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The Flawed Explicit Safety Net: How Federally Sponsored Deposit Insurance Contributes to Financial Crisis

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NOTES

THE FLAWED EXPLICIT SAFETY NET: HOW FEDERALLY SPONSORED DEPOSIT INSURANCE CONTRIBUTES TO FINANCIAL CRISIS

*Nicholas J. Colombo**

In the spring of 2012, JPMorgan Chase and Co. (JP Morgan), one of the largest and most profitable banks in the United States, made a \$6 billion mistake. The issues all began in London, with a division of JP Morgan known as the Chief Investment Office (CIO). While the CIO's stated purpose was to use excess deposits to hedge against interest rate risk, it had in fact been responsible for earning approximately \$4 billion in profits for JP Morgan over the three previous years. This all came to a screeching halt when Bruno Iksil, now known as the "London Whale," took a series of high-risk positions in derivatives and credit default swaps (CDS). To date the incident has cost JP Morgan billions of dollars in losses and fines and resulted in the criminal prosecution of several individuals involved in the incident.

Politicians and commentators have held the London Whale incident up as another example of large complex financial institutions behaving badly, and have accordingly pushed for stronger measures to eliminate the implicit subsidies that make such entities and their bad behavior possible. Lacking from this debate has been any meaningful discussion of the impact that explicit subsidies, like deposit insurance, have on the financial system in the United States. This is despite the fact that the funds the CIO used to make such fantastic profits for JP Morgan were federally sponsored deposits. This Note describes how the explicit federal safety net, specifically federally sponsored deposit insurance, contributes to the creation of financial instability and, potentially, financial crisis. This Note then analyzes several proposed reforms that could alleviate these problems,

* I would like to thank Professor Zephyr Teachout for her invaluable guidance during the writing of this Note, Professor Richard Scott Carnell for taking the time to explain to me the intricacies of the regulation of financial institutions, my parents for reminding me that publishing something is a worthwhile endeavor, my grandparents for spending many years in difficult blue-collar jobs so that I could one day have the privilege of sitting comfortably in a library conducting academic research, my friends for being supportive and showing an interest in my work, and Ms. Laura Bryant for spending many a late night listening to me discuss highly esoteric aspects of the law of deposit insurance.

and, while continually advocating for increased attention to this issue, ultimately suggests a system of narrow depository institutions to solve it.

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INTRODUCTION

In the spring of 2012, Jamie Dimon, the head of JPMorgan Chase and Co. (JP Morgan), one of the largest and most profitable banks in the United States, announced that the bank had made a mistake¹—a \$6 billion mistake.² The issues all began in London with a division of JP Morgan known as the Chief Investment Office (CIO).³ The purpose of the CIO seemed entirely mundane. It used excess deposits to hedge against interest rate risk,⁴ or as JP Morgan itself described, the CIO “[i]s focused on managing the long-term structural assets and liabilities of the firm and is

1. Dan Fitzpatrick, Gregory Zuckerman & Liz Rappaport, *J.P. Morgan's \$2 Billion Blunder—Bank Admits Losses on Massive Trading Bet Gone Wrong; Dimon's Mea Culpa*, WALL ST. J., May 11, 2012, at A1.

2. Ben Protess & Jessica Silver-Greenberg, *Charges Against 2 Traders Fault JP Morgan for Lack of Oversight*, N.Y. TIMES, Aug. 15, 2013, at A1.

3. See Jessica Silver-Greenberg & Susanne Craig, *JPMorgan Trading Loss May Reach \$9 Billion*, N.Y. TIMES DEALBOOK (June 28, 2012, 2:30 AM), <http://dealbook.nytimes.com/2012/06/28/jpmorgan-trading-loss-may-reach-9-billion/>.

4. *Id.*

not focused on short-term profits.”⁵ At the same time, this apparently did not stop the CIO from generating short-term profits, as it reportedly earned JP Morgan \$4 billion in profits during the three previous years.⁶ This all changed, however, when Bruno Iksil, now known as the “London Whale,” took a series of high-risk positions in credit derivatives.⁷ These positions turned out to be a mistake, a mistake that has to date cost JP Morgan approximately \$6 billion in losses, several billion in fines, and has resulted in criminal charges being filed against two other traders in the CIO.⁸

Politicians and commentators quickly decried the incident as another example of the problems with large complex financial institutions (LCFIs).⁹ They argued that big banks like JP Morgan are incentivized to engage in excessively risky activities because they are protected by an implicit government safety net known as “too big to fail” (TBTF).¹⁰ What was virtually ignored, however, was the fact that the CIO made all of its high-risk investments and profits using excess deposits.¹¹ These deposits were insured by the federal government under a program known as deposit insurance, a government program that, as part of the explicit federal safety net for banks,¹² allows commercial banks like JP Morgan to acquire funds at an artificially low price, essentially amounting to a federal subsidy.¹³ In other words, one could just as easily argue that JP Morgan was incentivized to make risky investments through the CIO because of the federal subsidy provided by deposit insurance.

This Note will describe how the explicit federal safety net, specifically federally sponsored deposit insurance, contributes to the creation of financial instability and, potentially, financial crisis. Part I describes the history of deposit insurance in the United States and how it functions currently. It also discusses the history of banking in the United States and how banks became a part of the LCFIs that dominate the financial services industry today. Part II of this Note describes how federally sponsored deposit insurance creates perverse incentives for banks to engage in certain high-risk activities and offers some examples of the repercussions. Part III examines several potential solutions to this problem, including possible

5. Gregory Zuckerman & Katy Burne, “*London Whale*” Rattles Debt Market, WALL ST. J., Apr. 6, 2012, at A1.

6. See Silver-Greenberg & Craig, *supra* note 3.

7. *Id.*

8. Ben Protess & Jessica Silver-Greenberg, *supra* note 2.

9. Scott Patterson, “*Whale*” Capsized Banks’ Rule Effort, WALL ST. J., Dec. 28, 2012, at C1.

10. Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem*, 89 OR. L. REV. 951, 954 (2011). Under this theory, big banks are able to engage in highly speculative activities because they enjoy protection from an implicit government safety net, and expect that the government will bail them out with public funds in a crisis.

11. See Silver-Greenberg & Craig, *supra* note 3.

12. The explicit federal safety net consists of federally sponsored deposit insurance, the Federal Reserve’s discount lending window, and the Federal Reserve’s payment system. See Wilmarth, *supra* note 10, at 1023 n.308.

13. See *infra* Part II.

legal adjustments to deposit insurance, restrictions on the abilities of banks, and reforms to the entire structure of the banking and financial services industry. Finally, Part IV of this Note offers a set of reforms to the law designed to eliminate perverse incentives, protect depositors, increase economic stability, and encourage profitability for banks and financial institutions.

I. THE BACKGROUND OF DEPOSIT INSURANCE, BANKS, AND FINANCIAL INSTITUTIONS

This Part discusses all of the relevant background information regarding deposit insurance in the United States. Part I.A provides an exhaustive history of deposit insurance in the United States from the early 1800s to the present, as well as the history of the Federal Deposit Insurance Corporation (FDIC). It concludes with a discussion of the changes made by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), including the creation of the Orderly Liquidation Authority. Part I.B provides a detailed description of the way deposit insurance currently operates in the United States. Part I.C describes the laws that allowed banks to develop into LCFIs, and Part I.D details the laws, known as sections 23A and 23B, that govern the interactions between banks, their affiliates, and subsidiaries within LCFIs.

A. *A Tale As Old As Time: The History of Deposit Insurance in the United States*

This Part provides an exhaustive history of deposit insurance in the United States from the early 1800s to the present, as well as the history of the FDIC. Part I.A.1 discusses why a system of deposit insurance is necessary. Part I.A.2 illustrates how early systems of deposit insurance worked in the United States, and Part I.A.3 describes how a federally sponsored deposit insurance system was ultimately created in the United States. Lastly, Parts I.A.4 and I.A.5 systematically review all of the legislative changes that have been made to the system since its inception, including those contained in Dodd-Frank.

1. Don't Let the Depositors Run Out on Me: Why Banks Need Deposit Insurance

Prior to 1863, virtually all banks were state-chartered institutions.¹⁴ The National Banking Act of 1863¹⁵ changed that by establishing a national banking charter and creating the dual banking system that still exists in the United States today.¹⁶ Banks are generally institutions of limited power,

14. See DAVID H. CARPENTER & M. MAUREEN MURPHY, CONG. RESEARCH SERV., R41181, PERMISSIBLE SECURITIES ACTIVITIES OF COMMERCIAL BANKS UNDER THE GLASS-STEAGALL ACT (GSA) AND THE GRAMM-LEACH-BLILEY ACT (GLBA) 3 (2010).

15. National Banking Act of 1863, ch. 58, 12 Stat. 665.

16. See CARPENTER & MURPHY, *supra* note 14, at 3.

and both their charters and the law limit their activities to the “business of banking.”¹⁷ Structurally, banks are institutions that present unique challenges. First, they are highly leveraged entities that hold assets much less liquid than their liabilities.¹⁸ Specifically, banks fund loans that are illiquid and difficult to value with deposits that are withdrawable upon demand,¹⁹ and keep relatively little cash on reserve, usually only enough to meet customers’ anticipated demand.²⁰ Second, banks are incredibly important to the national economy, providing a place for citizens to store their savings and furnishing loans to finance businesses.²¹

This creates the potential for a problem. If depositors withdraw more cash than anticipated, and do so without giving the bank sufficient time to liquefy its assets, the result will be a bank failure.²² Most of the time, banks are accurately able to anticipate depositor demand and maintain enough cash on hand.²³ However, even the best calculations and preparations are rendered moot in a panic. If depositors for some reason come to believe that their bank is at risk of collapsing, many of them, even those who had not planned to, will rush to the bank to withdraw their funds.²⁴ This is known as a bank run.²⁵ The result, regardless of whether the bank was financially troubled or not, is a bank failure.²⁶ If the panic is widespread and several banks fail, the subsequent shock to the banking industry can cause widespread economic turmoil.²⁷

The primary goal of deposit insurance, therefore, is to create stability in the banking industry by helping to prevent the panic that leads to bank runs in the first place.²⁸ The plan operates under the hope that by providing insurance for depositors’ funds, depositors will be less fearful of a bank’s health, less likely to run on banks, and less likely to cause unnecessary bank failures.²⁹ Furthermore, a system of federally sponsored deposit insurance

17. See 12 U.S.C. § 24 (Seventh) (2012). The Office of Comptroller of the Currency (OCC) has broad authority to determine what constitutes the “business of banking.” See *NationsBank of N.C. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251, 258 n.2 (1995). Many banks also exist under the corporate structure of a Financial Holding Company (FHC). FHCs are permitted to engage in a wide variety of finance-related activities entirely unrelated to commercial banking. Thus, banks within a FHC become affiliated with other financial institutions. 12 U.S.C. § 1843 (2012).

18. See RICHARD SCOTT CARNELL ET AL., *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 309 (Vicki Been et al. eds., 4th ed. 2009); Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 309.

19. CARNELL ET AL., *supra* note 18, at 309.

20. See *id.* at 309.

21. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-09-216, *FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM* 8 (2009).

22. See CARNELL ET AL., *supra* note 18, at 309.

23. See *id.* at 309.

24. See *id.* at 309–10.

25. See *id.* at 309.

26. See CARNELL ET AL., *supra* note 18, at 309.

27. See also Wilmarth, *supra* note 18, at 309.

28. See CARNELL ET AL., *supra* note 18, at 310.

29. See *id.* at 310.

is considered preferable because the federal government's vast financial resources allow it to instill a high level of confidence, which is necessary to make a deposit insurance system effective.³⁰ A secondary goal of deposit insurance is to protect small depositors.³¹

2. Tonight We're Going To Party Like It's 1829: Early Systems of Deposit Insurance in the United States

The early systems of deposit insurance in the United States can be broken down roughly into two periods: those created in the period from 1829 to 1866, and those created in the period from 1908 to 1930. In 1829, New York became the first state to create an insurance program covering bank deposits.³² Between 1831 and 1858, five other states—Vermont, Indiana, Michigan, Ohio, and Iowa—initiated programs as well.³³ These programs achieved varying levels of success. New York's, Vermont's, and Michigan's systems all failed.³⁴ The most successful of the six programs was Indiana's, which relied on a system of unlimited mutual liability and self-regulation by banks.³⁵ During its thirty year history, it saw not a single bank fail.³⁶ Ultimately, all of these systems ceased to exist by 1865 once national bank charters became more popular.³⁷

Between 1907 and 1917, eight other states adopted deposit insurance schemes³⁸: Kansas, Mississippi, Nebraska, North Dakota, South Dakota, Oklahoma, Washington, and Texas.³⁹ The systems were all very similar,⁴⁰ and a majority also granted supervisory authority to state governments to regulate member banks.⁴¹

Supervision turned out to be the biggest problem. The combination of understaffing, insufficient funding, and fraud made it impossible for the supervisory systems to be effective.⁴² This created an incentive for insured banks to take advantage of cross-subsidization by engaging in excessive

30. See *id.* at 310–11; see also George G. Kaufman, *Bank Failures, Systemic Risk, and Bank Regulation*, 16 CATO J. 17, 24 (1996) (noting that FDIC deposit insurance has prevented bank runs).

31. See Nancy J. Coppola, *Increased Federal Deposit Insurance Coverage: At What Cost?*, 6 N.C. BANKING INST. 429, 431 (2002).

32. See FED. DEPOSIT INS. CORP., FEDERAL DEPOSIT INSURANCE CORPORATION: THE FIRST FIFTY YEARS 13 (1984); Charles W. Calomiris, *Is Deposit Insurance Necessary? A Historical Perspective*, 50 J. ECON. HIST. 283, 286 (1990).

33. See FED. DEPOSIT INS. CORP., *supra* note 32, at 14.

34. See Calomiris, *supra* note 32, at 286–87. New York's failure was particularly acute due to poor funding from limits on annual premiums and ineffectual oversight. See *id.*

35. *Id.* at 287–88; see also FED. DEPOSIT INS. CORP., *supra* note 32, at 14, 19.

36. Calomiris, *supra* note 32, at 287–88; see also FED. DEPOSIT INS. CORP., *supra* note 32, at 14, 19.

37. FED. DEPOSIT INS. CORP., *supra* note 32, at 22.

38. *Id.* at 24; see also Clifford F. Thies & Daniel A. Gerlowski, *Deposit Insurance: A History of Failure*, 8 CATO J. 677, 680 (1989).

39. FED. DEPOSIT INS. CORP., *supra* note 32, at 25–27 tbl. 2.4; see also Thies & Gerlowski, *supra* note 38, at 680.

40. FED. DEPOSIT INS. CORP., *supra* note 32, at 24–29.

41. *Id.* at 28; see also Calomiris, *supra* note 32, at 288.

42. See FED. DEPOSIT INS. CORP., *supra* note 32, at 28; Calomiris, *supra* note 32, at 288.

risk taking and maintaining low levels of capital.⁴³ These practices, combined with falling agricultural prices and other economic issues of the 1920s, caused many member banks to become insolvent⁴⁴ and doomed these systems.⁴⁵

3. I'll Be There For You: Crisis and the Creation of the FDIC

By the end of 1930, it became clear that the banking crisis was not just reserved to the small rural banks that had failed in the 1920s and doomed the most recent state insurance systems.⁴⁶ Banks all over the country suffered from liquidity issues, and bank runs became increasingly common.⁴⁷ The situation culminated in the banking crisis of 1933. As a result of several factors,⁴⁸ in early 1933, sudden withdrawal demands created "a panic of massive proportions."⁴⁹ By March 4, 1933, "every state in the Union had declared a bank holiday."⁵⁰

After the passage of the Emergency Banking Act of 1933, the immediate crisis began to subside and the discussion of long-term reform, including deposit insurance, began.⁵¹ Between 1886 and 1933, a total of 150 proposals for federally sponsored deposit insurance were made in Congress, all with very different elements.⁵²

Of the 150 bills, 118 provided for the establishment of an insurance fund out of which depositors' losses would be paid, 22 provided for United States government guaranty of deposits, and 10 required banks to purchase surety bonds guaranteeing deposits in full. . . . Eighty percent of the bills provided for insurance or guaranty of all deposits. . . . In nearly one-half of the bills the entire cost of deposit insurance . . . was to be met by assessments based upon total deposits or average total deposits. The rates of assessment ranged. . . . In a number of bills, assessments upon the banks were to be supplemented by appropriations from the United States government . . . [and many others also] called for a limit on the accumulation of funds by the insurance or guaranty system.⁵³

The bills also differed in their provisions for what organization of the U.S. government would administer the insurance system.⁵⁴

43. See Calomiris, *supra* note 32, at 288–89.

44. See FED. DEPOSIT INS. CORP., *supra* note 32, at 28. Between 1921 and 1929, an average of more than 600 banks per year failed. These were predominantly small rural banks like those insured by the state funds. See *id.* at 33.

45. See *id.* at 28; see also Calomiris, *supra* note 32, at 289.

46. See FED. DEPOSIT INS. CORP., *supra* note 32, at 33.

47. See *id.* at 33–37.

48. See *id.* at 36–38.

49. See *id.* at 38.

50. *Id.* A bank holiday occurs when the government suspends all banking transactions for a period of time, essentially closing all banks. See William L. Silber, *Why Did FDR's Bank Holiday Succeed?*, 15 FED. RES. BANK N.Y. ECON. POL'Y REV. 19 (2009).

51. See *id.* at 40.

52. See *id.* at 29.

53. See *id.* at 29–30.

54. See *id.* at 29.

Federally sponsored deposit insurance, however, did not lack opposition.⁵⁵ Critics, such as Senator Carter Glass of Virginia, the banking industry, and even President Franklin Roosevelt,⁵⁶ worried that the system would be ineffective, promote bad management, and be overly expensive.⁵⁷ However, the idea enjoyed widespread public support, and thus, when banking reform bills were proposed in each house of Congress in May 1933, both contained provisions for federally sponsored deposit insurance.⁵⁸ Both bills subsequently passed their respective houses and were sent to a joint conference committee.⁵⁹ On June 16, 1933, President Roosevelt signed the Banking Act of 1933 into law, creating federally sponsored deposit insurance in the United States.⁶⁰

4. I've Got Ninety-Nine Problems and Legislation To Fix Them All:
Legal Adjustments to Deposit Insurance from 1933–2008

Since the creation of the FDIC and federally sponsored deposit insurance in 1933, the system has undergone several changes due to various legislative enactments over the years. The Banking Act of 1933⁶¹ created the FDIC,⁶² a temporary deposit insurance plan to begin on January 1, 1934,⁶³ and a permanent plan to become effective six months later.⁶⁴ Under the temporary plan, depositor protection was limited to \$2,500 for each depositor.⁶⁵ The permanent plan provided full protection of the first \$10,000 for each depositor, 75 percent coverage for the next \$40,000 of deposits, and 50 percent coverage for all deposits in excess of \$50,000.⁶⁶ However, that system never took effect because of the passage of the Banking Act of 1935.⁶⁷

The Banking Act of 1935⁶⁸ created a new permanent plan insuring 100 percent of deposits up to \$5,000 for each depositor at an insured

55. *See id.* at 40–41.

56. *See* Coppola, *supra* note 31, at 432 (quoting Franklin Delano Roosevelt, who claimed that “insurance covering all banks would protect improvident operators from the consequences of their own folly”).

57. *See* FED. DEPOSIT INS. CORP., *supra* note 32, at 40–41.

58. *See id.* at 41.

59. *See id.* at 42–43.

60. *See id.* at 43.

61. Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified in scattered sections of 12 U.S.C.).

62. *See id.* § 8, 48 Stat. at 168 (current version at 12 U.S.C. § 1811 (2012)); FED. DEPOSIT INS. CORP., *supra* note 32, at 43.

63. *See* Banking Act of 1933 § 8, 48 Stat. at 172–80 (current version at 12 U.S.C. § 1815); FED. DEPOSIT INS. CORP., *supra* note 32, at 43.

64. *See* Banking Act of 1933 § 8, 48 Stat. at 172–73 (current version at 12 U.S.C. § 1821); FED. DEPOSIT INS. CORP., *supra* note 32, at 43.

65. *See* Banking Act of 1933 § 8, 48 Stat. at 179 (current version at 12 U.S.C. § 1821); FED. DEPOSIT INS. CORP., *supra* note 32, at 44.

66. *See* Banking Act of 1933 § 8, 48 Stat. at 173 (current version at 12 U.S.C. § 1821); FED. DEPOSIT INS. CORP., *supra* note 32, at 44.

67. *See* FED. DEPOSIT INS. CORP., *supra* note 32, at 44.

68. Banking Act of 1935, Pub. L. No. 74-305, 49 Stat. 684 (codified in scattered sections of 12 U.S.C.).

institution.⁶⁹ The 1935 Act also set the assessment rate at one-twelfth of 1 percent of total deposits.⁷⁰ Lastly, the 1935 Act gave the FDIC broader powers to facilitate mergers or consolidations of insured banks.⁷¹

In 1950, the Federal Deposit Insurance Act⁷² created a rebate system.⁷³ This reflected concerns that the assessment rate was too high and the insurance fund sufficiently funded.⁷⁴ The 1950 Act also increased the coverage of insured deposits to \$10,000.⁷⁵ Over the next several years, various legislative measures increased the limit to \$15,000 in 1966, \$20,000 in 1969, and \$40,000 in 1974.⁷⁶ In addition, in 1978, the insurance limit for certain types of retirement accounts was also raised to \$100,000.⁷⁷ In 1980, the basic limit was raised to \$100,000 for all types of deposit accounts⁷⁸ after the passage of the Depository Institutions Deregulation and Monetary Control Act (DIDMCA).⁷⁹ DIDMCA also set a minimum designated reserve ratio (DRR) of 1.10 percent of estimated insured deposits and a maximum DRR of 1.40 percent.⁸⁰

The next significant changes to the FDIC and deposit insurance in the United States came in 1989 and 1991. In 1989, the Financial Institutions Reform, Recovery, and Enforcement Act⁸¹ (FIRREA) gave the FDIC responsibility over insuring the deposits of savings and thrift institutions.⁸² FIRREA also created two separate insurance funds: the Savings Association Insurance Fund (SAIF) and the Bank Insurance Fund (BIF).⁸³ Lastly, FIRREA set the DRR at 1.25 percent of estimated insured deposits, but allowed the FDIC to increase it to 1.50 percent if necessary.⁸⁴

69. *See id.* § 101, 49 Stat. at 694 (current version at 12 U.S.C. § 1821).

70. *See id.* § 101, 49 Stat. at 688 (current version at 12 U.S.C. § 1817).

71. *See id.* § 101, 49 Stat. at 694–700 (current version at 12 U.S.C. § 1821).

72. Federal Deposit Insurance Act of 1950, Pub. L. No. 81-797, 64 Stat. 873.

73. *See id.* § 2, 64 Stat. at 877–78 (current version at 12 U.S.C. § 1817).

74. *See* FED. DEPOSIT INS. CORP., *supra* note 32, at 58. The rebate system functioned by subtracting the FDIC's operating expenses and insurance losses from gross assessment income, and then splitting the remainder with 60 percent going back to insured institutions and 40 percent staying with the FDIC. *See id.* at 60.

75. Federal Deposit Insurance Act of 1950 § 3, 64 Stat. at 875 (current version at 12 U.S.C. § 1821).

76. *See* FED. DEPOSIT INS. CORP., *supra* note 32, at 69.

77. *See id.*

78. *See* Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 308m, 94 Stat. 132, 147 (current version at 12 U.S.C. § 1821); FED. DEPOSIT INS. CORP., *supra* note 32, at 69.

79. Depository Institutions Deregulation and Monetary Control Act of 1980, 94 Stat. at 132 (current version at 12 U.S.C. § 1821).

80. *Id.* § 308, 94 Stat. at 148 (current version at 12 U.S.C. § 1817(b)(3)(B)).

81. Pub. L. No. 101-73, 103 Stat. 183 (1989). FIRREA was passed largely in response to the savings and loan crisis of the 1980s. *See* Coppola, *supra* note 31, at 433–34.

82. *See* Coppola, *supra* note 31, at 433–34.

83. Financial Institutions Reform, Recovery, and Enforcement Act § 211, 103 Stat. at 219 (codified as amended in 12 U.S.C. § 1821(a)(4)).

84. *See id.* § 208, 103 Stat. at 207 (current version at 12 U.S.C. § 1817(b)(3)(B)).

The Federal Deposit Insurance Corporation Improvement Act of 1991⁸⁵ (FDICIA) made two substantial changes to the operation of the FDIC. First, it required the FDIC to develop a system of risk-based deposit insurance premiums.⁸⁶ Second, it imposed a least cost rule on the FDIC when resolving a failed or closed insured institution.⁸⁷ Essentially, the least cost rule requires that the FDIC adopt the resolution method that is least costly to the deposit insurance fund.⁸⁸ In addition, the FDICIA kept the DRR at 1.25 percent of estimated insured deposits, but allowed the FDIC to raise it to a higher number if justified by the circumstances.⁸⁹

After the FDICIA, deposit insurance in the United States experienced relatively little change for the rest of the twentieth century. As Rebecca Duffy states in her article on deposit insurance, “The late 1990s did not lend itself as an era for vast discussion of deposit insurance reform because the economy was booming and banking conditions were favorable—meaning any discussion of deposit insurance reform was essentially tabled.”⁹⁰ The lone exception was the Deposit Insurance Funds Act of 1996.⁹¹ That act prohibited the FDIC from charging premiums to well-capitalized institutions as long as the funds’ reserve ratio exceeded the DRR.⁹²

However, as the twenty-first century began, discussion of reform returned.⁹³ The result was the Federal Deposit Insurance Reform Act of 2005⁹⁴ (FIRA). FIRA made a number of significant changes to the deposit insurance system in the United States. First, FIRA merged the BIF and SAIF into one common fund, the Deposit Insurance Fund (DIF).⁹⁵ Second,

85. Pub. L. No. 102-242, 105 Stat. 2236 (codified as amended in scattered sections of 12 U.S.C.).

86. Federal Deposit Insurance Corporation Improvement Act of 1991 § 302, 105 Stat. at 2245, 2349 (codified as amended at 12 U.S.C. § 1817(b)(1)); *see also* Viral V. Acharya, João A. C. Santos & Tanju Yorulmazer, *Systemic Risk and Deposit Insurance Premiums*, 18 FED. RES. BANK N.Y. ECON. POL’Y REV. 89, 90 (2010) (“Throughout most of the FDIC’s history, deposit insurance premiums have been independent of bank risk, mainly because of the difficulty assessing that risk. Between 1935 and 1990, the FDIC charged flat deposit insurance premiums at the rate of approximately 8.3 cents per \$100 of insured deposits.”).

87. Federal Deposit Insurance Corporation Improvement Act of 1991 § 141, 105 Stat. at 2273 (current version at 12 U.S.C. § 1823(c)(4)(A)(ii)).

88. *See* Richard Scott Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 ANN. REV. BANKING L. 317, 363 (1993).

89. Federal Deposit Insurance Corporation Improvement Act of 1991 § 302, 105 Stat. at 2346 (current version at 12 U.S.C. § 1817(b)(3)(B)).

90. Rebecca N. Duffy, *The Moral Hazard of Increased Deposit Insurance: What the 1980s Savings and Loan Crisis Can Teach Us About Responding to the Current Financial Crisis*, 59 DRAKE L. REV. 559, 563 (2011).

91. Federal Deposit Insurance Funds Act of 1996, Pub. L. No. 204-208, 110 Stat. 3009-479 (current version at 12 U.S.C. § 1817(b)(2)(B)).

92. *Id.* § 2708, 110 Stat. at 3009-497 (repealed by the Federal Deposit Insurance Reform Act of 2005, Pub. L. No. 109-171, § 2102(b), 120 Stat. 9 (2006)).

93. *See* Duffy, *supra* note 90, at 563. For a further discussion of the issues motivating reform during the early 2000s, *see* Coppola, *supra* note 31, at 436-48.

94. 120 Stat. 9 (codified as amended in scattered sections of 12 U.S.C.).

95. *See id.* § 2102, 120 Stat. at 9 (codified as amended in 12 U.S.C. § 1821(a)(4)); *see also* John L. Douglas et al., *Deposit Insurance Reform Enacted*, 123 BANKING L.J. 447, 448 (2006).

the FDIC was given the power to adjust the DRR annually within the range of 1.15 and 1.50 percent.⁹⁶ Third, if the DRR exceeded 1.35 percent, the FDIC was required to begin paying dividends to member institutions.⁹⁷ Fourth, the coverage on individual retirement accounts (IRAs) was raised to \$250,000.⁹⁸ Lastly, FIRA introduced a system to increase the \$100,000 coverage for basic deposits based on inflation.⁹⁹ This provision was scheduled to begin in 2010, but was never utilized due to the 2008 financial crisis.¹⁰⁰ However, it allows the FDIC and the Board of Directors of the National Credit Union Administration to raise the \$100,000 cap every five years to account for inflation, with the multiplier coming from the Department of Commerce's Personal Consumption Expenditure Chain-Type Price Index.¹⁰¹

The next significant changes to deposit insurance in the United States came during and after the 2008 financial crisis. The Emergency Economic Stabilization Act of 2008 temporarily increased the standard minimum deposit insurance amount (SMDIA) from \$100,000 to \$250,000 per depositor.¹⁰² The Helping Families Save Their Homes Act of 2009 extended this temporary increase.¹⁰³ However, these changes were only temporary measures aimed at creating immediate economic stability. Significant and permanent change to deposit insurance and the operation of the FDIC did not come until the passage of Dodd-Frank in 2010.

5. When There's Something Wrong with Your LCFI, Who You Gonna Call?: Dodd-Frank, Deposit Insurance, and the Orderly Liquidation Authority

In general, Dodd-Frank's stated goal was to end TBTF and prevent bailouts—in other words, to deal with the problems of the implicit government safety net.¹⁰⁴ However, it also included key changes to the operation of deposit insurance and the FDIC. In regards to deposit insurance, Dodd-Frank permanently increased the SMDIA from \$100,000 to \$250,000, and provided for unlimited coverage on non-interest bearing transactional accounts until December 31, 2012.¹⁰⁵ Dodd-Frank also raised

96. Federal Deposit Insurance Reform Act of 2005 § 2105, 120 Stat. at 14 (current version at 12 U.S.C. § 1817(b)); *see also* Douglas et al., *supra* note 95, at 448.

97. Federal Deposit Insurance Reform Act of 2005 § 2107, 120 Stat. at 16 (current version at 12 U.S.C. § 1817 (e)); *see also* Douglas et al., *supra* note 95, at 448.

98. Federal Deposit Insurance Reform Act of 2005 § 2103, 120 Stat. at 11–12 (current version at 12 U.S.C. § 1821); *see also* Douglas et al., *supra* note 95, at 447.

99. Federal Deposit Insurance Reform Act of 2005 § 2103, 120 Stat. at 10 (current version at 12 U.S.C. § 1821(a)(1)(F)).

100. *See infra* note 105 and accompanying text.

101. 12 U.S.C. § 1821(a)(1)(F); *see also* Douglas et al., *supra* note 95, at 449.

102. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 136, 122 Stat. 3765, 3799 (current version at 12 U.S.C. § 5241 (2012)).

103. Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, § 204, 123 Stat. 1632, 1648–52 (codified at 12 U.S.C. § 5241).

104. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

105. *Id.* § 343, 124 Stat. at 1540 (codified at 12 U.S.C. § 1821).

the minimum DRR to 1.35 percent, removed any upper limit on the fund,¹⁰⁶ and eliminated the requirement that the FDIC provide refunds when the DRR is between 1.35 and 1.50 percent.¹⁰⁷

Additionally, Dodd-Frank instructed the FDIC to promulgate regulations redefining the assessment base as the average total consolidated assets of an insured depository institution minus tangible equity.¹⁰⁸ In 2011, pursuant to this mandate, the FDIC finalized the implementing regulation.¹⁰⁹ At the same time, the FDIC also finalized new regulations altering the calculation of assessments for large insured institutions and highly complex insured institutions.¹¹⁰ Under these regulations, institutions will no longer have their base assessment rates calculated using the four risk categories.¹¹¹ Instead, they will be calculated using a scorecard that combines the CAMELS¹¹² rating system with other financial measures.¹¹³

Most importantly, Dodd-Frank gave the FDIC a vastly important new power: the Orderly Liquidation Authority (OLA).¹¹⁴ Under the OLA, if the Secretary of the Treasury, after recommendations by the Federal Reserve Board of Governors (FRB) and the FDIC, believes that the impending failure of a LCFI would impact the financial stability of the United States, the Secretary can appoint the FDIC as receiver of the institution.¹¹⁵ If the institution's board does not consent to the receivership, the Secretary can petition the D.C. District Court to impose an involuntary one.¹¹⁶ The scope of judicial review is limited to whether the Secretary's determination that the institution is in danger of default is arbitrary and capricious.¹¹⁷

Unlike when it is appointed as a receiver for a bank, the FDIC's receivership powers under the OLA are specifically circumscribed.¹¹⁸ Under the OLA, the FDIC is required to impose losses on unsecured

106. *Id.* § 334(a), 124 Stat. at 1539 (codified as amended at 12 U.S.C. § 1817(b)(3)(B)).

107. *Id.* § 332(d), 124 Stat. at 1539 (codified as amended at 12 U.S.C. § 1817(e)).

108. *Id.* § 331(b), 124 Stat. at 1538 (codified as amended at 12 U.S.C. § 1817).

109. 12 C.F.R. § 327 (2013).

110. *See* Assessments, Large Bank Pricing, 76 Fed. Reg. 10,672 (Feb. 25, 2011) (to be codified at 12 C.F.R. pt. 327).

111. For more on the traditional four risk categories, see *infra* notes 146–50 and accompanying text.

112. The CAMELS rating system is an overall rating of a bank's condition created by examining six specific components: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity market risk. *See* CARNELL ET AL., *supra* note 18, at 317–18, 633–36.

113. *See* Assessments, Large Bank Pricing, 76 Fed. Reg. at 10,688.

114. Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 202–217, 124 Stat. at 1444–520 (codified at 12 U.S.C. §§ 5381–5394).

115. *Id.* § 203, 124 Stat. at 1450 (codified at 12 U.S.C. § 5383); *see also* Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REG. 151, 190–91 (2011).

116. Dodd-Frank Wall Street Reform and Consumer Protection Act § 202(a)(1), 124 Stat. at 1444–45 (codified as amended at 12 U.S.C. § 5382).

117. *Id.*

118. For banks, the FDIC's liquidation authority is only limited by the requirement that it pursue the least-cost resolution strategy. *See supra* notes 86–87 and accompanying text.

creditors and shareholders, remove management and board members responsible for the institution's problems,¹¹⁹ and treat amounts owed to highly compensated employees as unsecured claims.¹²⁰ Additionally, the FDIC cannot create a conservatorship or offer open bank assistance, but can only liquidate the institution.¹²¹ However, the FDIC has broad authority to provide financing to facilitate an institution's liquidation.¹²² Funding for the liquidation comes from the Orderly Liquidation Fund (OLF), which is in turn funded by borrowing from the Treasury Department.¹²³ The fund is ultimately repaid through the sale of assets, authorized recoveries, and, if necessary, an ex post risk-based assessment on large bank holding companies (BHCs) and systemically important financial institutions¹²⁴ (SIFIs).¹²⁵

The goal of the OLA is to eliminate the necessity that regulators pick between two equally unsavory choices when dealing with a troubled financial institution.¹²⁶ During the 2008 financial crisis, financial regulators only had two options: allow a financial institution to fail and hurt the economy or create a politically unpopular bailout.¹²⁷ Dodd-Frank made the OLA and FDIC receivership the only route for a troubled firm.¹²⁸ The result is an orderly liquidation that prevents economic shockwaves, and a resolution that does not use taxpayer money to save an institution from its own mistakes.¹²⁹

119. Dodd-Frank Wall Street Reform and Consumer Protection Act § 206, 124 Stat. at 1459 (codified at 12 U.S.C. § 5386).

120. *Id.* § 210(b)(1), 124 Stat. at 1475–76 (codified as amended at 12 U.S.C. § 5390); *see also* Gordon & Muller, *supra* note 115, at 190–94.

121. Dodd-Frank Wall Street Reform and Consumer Protection Act § 214(a), 124 Stat. at 1518 (codified as amended at 12 U.S.C. § 5394); *see also* Gordon & Muller, *supra* note 115, at 190–94.

122. Dodd-Frank Wall Street Reform and Consumer Protection Act § 204(d), 124 Stat. at 1455–56 (codified as amended at 12 U.S.C. § 5384); *see also* Gordon & Muller, *supra* note 115, at 190–94.

123. Dodd-Frank Wall Street Reform and Consumer Protection Act § 210(n), 124 Stat. at 1506–09 (codified as amended at 12 U.S.C. § 5390); *see also* Gordon & Muller, *supra* note 115, at 190–94.

124. Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 210(n)–(o), 214, 124 Stat. at 1506–14, 1518 (codified as amended at 12 U.S.C. §§ 5390, 5394); *see also* Gordon & Muller, *supra* note 115, at 192.

125. The term SIFI in this Note refers to all institutions that are nonbank financial institutions regulated by the FRB under Dodd-Frank. Section 113 of Dodd-Frank gives the Financial Stability Oversight Council (FSOC) the power to subject nonbank financial institutions to regulation by the FRB if the FSOC “determines that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States.” 12 U.S.C. § 5323(a)(1). Accordingly, the term SIFI is intended to cover those institutions subjected to additional regulation under Dodd-Frank, due to their status as nonbank financial institutions that the FSOC has designated for FRB regulation, by virtue of their importance to the economy.

126. *See* Wilmarth, *supra* note 10, at 993.

127. *Id.*

128. *See* Gordon & Muller, *supra* note 115, at 152–53.

129. *See* Wilmarth, *supra* note 10, at 993.

However, the OLA has been criticized on a number of grounds, most prominently the lack of pre-funding for the OLF.¹³⁰ In his article, *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem*, Arthur E. Wilmarth, Jr. articulates four reasons why failure to pre-fund the OLF creates significant problems. First, in a time of financial crisis precipitating the need for the OLA, it is unlikely large BHCs and SIFIs will have the necessary funds to replenish the OLF with ex ante assessments.¹³¹ The result will be the use of a large amount of taxpayer funds to pay for the liquidations.¹³² Second, the system unfairly forces the most prudent surviving institutions to pay for the costs of the excessive risks of the failed institutions.¹³³ Third, a prefunded OLF would encourage institutions to monitor each other's conduct in order to avoid depleting the fund and triggering special assessments.¹³⁴ Fourth, paying a risk-based assessment to a prefunded OLF would force SIFIs to internalize the cost that their potential failure places on the government and taxpayers.¹³⁵ Furthermore, if the assessments were accurately calibrated to risk, they would reduce moral hazard and shield the government and taxpayers from potential exposure.¹³⁶

It is also not entirely clear that the receivership system created in the OLA is actually preferable. Jeffrey Gordon and Christopher Muller discuss this in their article *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Relief Fund*.

In a systemic emergency, stabilization of the overall financial sector may be necessary. The mechanism available under Dodd-Frank, receiverships imposed on multiple major financial firms on a narrow timeframe, will be difficult to administer and will amount to government nationalization of a large portion of the financial sector with unpredictable consequences. Such a massive intervention is hardly the best way to avoid the breakout of financial sector distress into the real economy. Moreover, the threat of this strategy could accelerate the slide from financial sector instability to financial sector crisis. An alternative approach would require recourse to Congress for additional authority in the middle of a crisis. This strategy is also likely to result in the breakout of the financial crisis into the real economy. Even worse, a legislative failure in the crucible of an emergency would be a major blow to public confidence and a genuine catastrophe for the real economy.¹³⁷

Therefore, in a financial crisis, assisting struggling institutions or bailing them out may be more effective in preventing a crisis than OLA

130. Earlier versions of the legislation did provide for a prefunded OLF, but Republican resistance to the idea resulted in it being removed from the final legislation. *Id.* at 1015–17.

131. Wilmarth, *supra* note 10, at 1015–20.

132. *Id.* at 1015–20.

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.* at 1020–22.

137. See Gordon & Muller, *supra* note 115, at 204.

receivership.¹³⁸ Gordon and Muller thus propose that direct assistance should be provided to firms in a time of crisis through a prefunded systemic emergency relief fund.¹³⁹

B. I'll Be Watching You: The Current Operation of Federally Sponsored Deposit Insurance in the United States

What is clear from the discussion in Part I.A is that, in the approximate eighty years since its inception, federally sponsored deposit insurance in the United States has undergone a number of complex changes. Therefore, this section offers a concise description of the current state of the law, and the processes by which the FDIC operates. The FDIC is an independent agency of the federal government, and FDIC insurance covers all deposit accounts including checking, savings, and money market deposit accounts.¹⁴⁰ The current level of insurance is \$250,000 per depositor, per insured bank, for each account ownership category.¹⁴¹ In the event of a bank failure, a depositor at an FDIC-insured bank is typically able to recover their funds quickly with little delay.¹⁴² The FDIC does not cover many of the other financial products that banks offer like stocks, bonds, life insurance policies, and securities.¹⁴³

FDIC deposit insurance coverage is provided by the DIF.¹⁴⁴ The DIF is funded by premiums paid by insured depository institutions, typically banks.¹⁴⁵ These premiums are calculated by multiplying an institution's assessment rate by its assessment base.¹⁴⁶ For many institutions, the assessment rate is determined by a number of factors. The most important factor is which of four possible risk categories the insured institution falls into.¹⁴⁷ Category I is the lowest risk and Category IV is the highest. The FDIC's designation of an institution into a risk category is primarily based on capital¹⁴⁸ levels and the FDIC's evaluations of the institution.¹⁴⁹ Once a

138. *Id.*

139. See Gordon & Muller, *supra* note 115, at 204–05.

140. *Deposit Insurance Summary*, FED. DEPOSIT INS. CORP., <http://www.fdic.gov/deposit/deposits/dis/index.html> (last updated Oct. 17, 2013).

141. See *id.*; see also FED. DEPOSIT INS. CORP., *supra* note 32, at 70–72 (discussing the complex rules regarding ownership categories).

142. See George G. Kaufman & Steven A. Seelig, *Post-resolution Treatment of Depositors at Failed Banks: Implications for the Severity of Banking Crises, Systemic Risk, and Too-Big-To-Fail* 8 (Int'l Monetary Fund, Working Paper No. 83, 2001). But see FED. DEPOSIT INS. CORP., *supra* note 32, at 83–85 (noting delays may occur in paying deposits).

143. *Deposit Insurance Summary*, *supra* note 140.

144. *The Deposit Insurance Fund*, FED. DEPOSIT INS. CORP., <http://www.fdic.gov/deposit/insurance/index.html> (last updated Aug. 29, 2013).

145. See *Deposit Insurance Summary*, *supra* note 140.

146. Assessments, Large Bank Pricing, 76 Fed. Reg. 10,672, 10,673 (Feb. 25, 2011) (to be codified at 12 C.F.R. pt. 327).

147. See *id.* at 10,672–73.

148. For banks, capital is the firm's net worth or equity. A firm's equity is essentially all that would be left if it paid off all of its creditors. Accordingly, it equals the firm's total assets minus the firm's total liabilities. Capital is important because the more capital a bank has, or the more that its assets exceed its liabilities, the more likely it is to be able to pay back its creditors. Total capital, or total equity, is Tier 1 capital plus Tier 2 capital. Tier 1

risk category is determined, the final assessment rate is calculated after factoring in a number of other adjustments.¹⁵⁰ The assessment base is determined by subtracting the institution's average tangible equity from the institution's average consolidated total assets.¹⁵¹

The system operates differently for large insured institutions¹⁵² and highly complex institutions.¹⁵³ For these institutions, base assessment rates are not calculated using risk categories, but instead using a scorecard that combines the CAMELS rating system with other financial measures.¹⁵⁴ Once the base assessment rate is calculated, the FDIC reserves the right to adjust it based on significant factors not captured in the scorecards.¹⁵⁵ The scorecards are different for large insured institutions and highly complex institutions.¹⁵⁶

By law, the minimum designated reserve ratio of the DIF cannot fall below 1.35 percent of estimated insured deposits.¹⁵⁷ If it does, the FDIC is required to adopt a restoration plan to restore its funds.¹⁵⁸ There is no cap on how high the DRR may be, and the FDIC may determine the appropriate level every year.¹⁵⁹ However, if the DRR exceeds 1.50 percent of estimated insured deposits, the FDIC is permitted to, but not required to, issue dividends to insured institutions.¹⁶⁰

In the event that an insured depository institution fails or is closed by its primary regulator,¹⁶¹ the FDIC may take a number of actions. First, in almost every case, the process begins with the FDIC being appointed as receiver of a failed bank.¹⁶² Second, the FDIC must decide between the use

capital is more permanent, reliable, and resilient, and consists of specific types of equity. Tier 2 capital is everything else that qualifies as capital, and it is less preferable. *See* CARNELL ET AL., *supra* note 18, at 252–65.

149. *See* Assessments, Large Bank Pricing, 76 Fed. Reg. at 10,672.

150. *See id.* at 10,672–73.

151. *See id.* at 10,678.

152. These are banks with \$10 billion or more in total assets in December 2006, or for four consecutive quarters since then. *See id.* at 10,674 n.15.

153. These are banks with \$50 billion or more in total assets that have a relationship with another U.S. company with assets of \$500 billion or more. *See id.* at 10,688 n.52.

154. *See id.* at 10,688.

155. *See id.* at 10,699.

156. *See id.* at 10,689, 10,695.

157. *See id.* at 10,673; *see also* *The Deposit Insurance Fund*, *supra* note 144.

158. *The Deposit Insurance Fund*, *supra* note 144.

159. *See* Assessments, Large Bank Pricing, 76 Fed. Reg. at 10,673.

160. *See id.* at 10,673–74; *see also* *The Deposit Insurance Fund*, *supra* note 144.

161. For example, a bank's primary federal regulator may close a bank and place it in conservatorship or receivership because it is severely undercapitalized and has not complied with the requirements set forth in the FDICIA. *See* Carnell, *supra* note 88, at 327–28 (discussing in depth the function and difficulty of defining the least-cost rule).

162. FED. DEPOSIT INS. CORP., *supra* note 32, at 83 (“When a national bank is closed, the FDIC is automatically appointed receiver by the Comptroller of the Currency. . . . [I]t is the exception when the FDIC is not appointed.”); *see also* CARNELL ET AL., *supra* note 18, at 694 (“The FDIC pays insured claims from the insurance fund and recoups what it can by selling the failed bank's assets. The more efficient the resolution process, the smaller the FDIC's loss. By acting as the failed bank's receiver, the FDIC controls the process and has an opportunity to minimize its own loss.”).

of two processes, broadly described as the payout method and the purchase and assumption method (P&A method).¹⁶³ By law, the FDIC is required to use whatever process would be the least costly in that instance.¹⁶⁴ In the payout method, the FDIC pays off insured deposits directly, and “becomes a creditor of the receivership for the amount it advances.”¹⁶⁵ The FDIC receivership then liquidates the bank’s assets, attempting to get the highest price possible to refund itself and the other creditors.¹⁶⁶ In the P&A method, the FDIC engineers a sale of the deposits and loans of the failed institution to another institution.¹⁶⁷ “Customers of the failed institution automatically become customers of the assuming institution . . . [and] the transition is seamless from the customer’s point of view.”¹⁶⁸

Lastly, there are two ways the FDIC may take action before an insured institution is closed or fails. First, the FDIC has the power to provide assistance to banks through loans or purchase of assets.¹⁶⁹ Second, the FDIC has the power to facilitate a merger or acquisition of a failing bank by making loans, purchasing assets, and providing guarantees.¹⁷⁰

*C. It’s the End of the World As We Know It: The Rise of
the Modern TBTF LCFIs*

Today, many of the commercial banks insured by the FDIC are part of LCFIs and are legally organized under the umbrella of Financial Holding Companies (FHCs).¹⁷¹ These affiliations were initially prohibited under the Banking Act of 1933, colloquially referred to as the Glass-Steagall Act (GSA), which forced the separation of commercial banking from investment banking (i.e., securities firms).¹⁷² Specifically, section 20 of the GSA prohibited member banks from affiliating with a business “engaged principally” in investment banking.¹⁷³ The separation between commercial and investment banks was later strengthened in 1956 by the Bank Holding Company Act (BHCA) requirement that BHCs, or companies owning or controlling banks, could not own or control any company that was not a

163. FED. DEPOSIT INS. CORP., *supra* note 32, at 81–88.

164. *See* CARNELL ET AL., *supra* note 18, at 694; *see also* Carnell, *supra* note 88, at 363–67.

165. FED. DEPOSIT INS. CORP., *supra* note 32, at 85.

166. *Id.*

167. *Id.* at 87–94; *see also* CARNELL ET AL., *supra* note 18, at 731 (noting the difficult statutory requirements the FDIC must overcome to provide open bank assistance).

168. *Who Is the FDIC?*, FED. DEPOSIT INS. CORP., <http://www.fdic.gov/about/learn/symbol/index.html> (last updated Jan. 18, 2013).

169. FED. DEPOSIT INS. CORP., *supra* note 32, at 94–97.

170. *Id.* at 81.

171. Wilmarth, *supra* note 18, at 220.

172. *See* Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified in scattered sections of 12 U.S.C.); *see also* CARPENTER & MURPHY, *supra* note 14, at 6.

173. *See* Banking Act of 1933 § 20, 48 Stat. at 188–89, *repealed by* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 101(a), 113 Stat. 1338, 1341 (1999); *see also* CARPENTER & MURPHY, *supra* note 14, at 6.

bank or engaged in an activity not related to banking.¹⁷⁴ These prohibitions remained unchallenged for several decades as many strongly believed that the connection between commercial banking and securities firms had led to the Great Depression.¹⁷⁵

This view began to change in the late 1970s and early 1980s.¹⁷⁶ High interest rates drove consumers to put their funds in interest bearing accounts,¹⁷⁷ businesses began to rely on securitization for short term funding,¹⁷⁸ and new competitors entered the market.¹⁷⁹ Banks suddenly found their market share¹⁸⁰ and profits¹⁸¹ steadily dropping, and they put pressure on their regulators to ease the restrictions imposed by the GSA.

While the Office of Comptroller of the Currency (OCC) responded by allowing commercial banks to engage in a wider variety of financial activities,¹⁸² the FRB responded by allowing ever more complex corporate combinations between banks and other financial entities. Supported by the U.S. Supreme Court's decision in *Board of Governors of the Federal Reserve System v. Investment Co. Institute*,¹⁸³ the FRB declared that bank subsidiaries could engage in activities involving certain bank ineligible securities without violating section 20, as long as these activities did not exceed a certain percentage of gross revenue.¹⁸⁴ Over time, the requirements became increasingly liberal,¹⁸⁵ and by 1996 the FRB had essentially allowed any large bank to affiliate with any large securities

174. See Bank Holding Company Act of 1956, Pub. L. No. 84-511, § 4, 70 Stat. 133, 135–37 (current version at 12 U.S.C. § 1843 (2012)).

175. See Arthur E. Wilmarth, Jr., *Did Universal Banks Play a Significant Role in the U.S. Economy's Boom-and-Bust Cycle of 1921–33? A Preliminary Assessment*, 4 CURRENT DEVS. MONETARY & FIN. L. 559, 590–91 (2005).

176. See CARPENTER & MURPHY, *supra* note 14, at 8.

177. Depositors shifted huge amounts of funds into money market mutual funds (MMMFs) that offer considerably higher yields to investors and many of the advantages of bank accounts such as demand withdrawal and check writing. See Wilmarth, *supra* note 18, at 239–40 & n.95.

178. See CARPENTER & MURPHY, *supra* note 14, at 8.

179. See WOLFGANG H. REINICKE, BANKING, POLITICS AND GLOBAL FINANCE 57 (1995).

180. *Id.* at 57, 95.

181. See CARPENTER & MURPHY, *supra* note 14, at 8.

182. See *id.* at 10; see also Eligibility of Securities for Purchase, Dealing in Underwriting and Holding by National Banks; Rulings Issued by the Comptroller, 47 Fed. Reg. 18,323 (Apr. 29, 1982) (current version at 12 C.F.R. ch. 1, pt. 1 (2013)).

183. 450 U.S. 46 (1981). The Court held that the FRB's determination of what constituted the business of banking under the BHCA was entitled to great deference. *Id.* at 56–58. It also found that the FRB's decision to allow bank subsidiaries to engage in certain investment activities did not violate the GSA, which only applied to banks and not subsidiaries. *Id.* at 63–65; see also MELANIE L. FEIN, SECURITIES ACTIVITIES OF BANKS 4-55 to -56 (3d ed. 2011) (stating that the holding effectively meant that bank affiliates or subsidiaries could legally engage in activities prohibited for banks themselves).

184. *Orders Issued Under Section 4 of the Bank Holding Company Act*, 73 FED. RES. BULL. 473, 475–77 (1987).

185. *Regulation Y Amendment*, 75 FED. RES. BULL. 751 (1989) (doubling the revenue requirement to 10 percent); see also REINICKE, *supra* note 179, at 114.

firm.¹⁸⁶ In 1998, the FRB approved the merger between Citibank and Travelers, making Citibank the largest banking organization in the world and allowing it to offer a full range of financial services.¹⁸⁷ Finally, in 1999, Congress overwhelmingly passed,¹⁸⁸ and President Clinton signed into law, the Gramm-Leach-Bliley Act (GLBA).¹⁸⁹ The GLBA effectively removed the barriers separating commercial banks, securities firms, and insurance companies, principally by repealing section 20 of the GSA and relevant provisions of the BHCA.¹⁹⁰ The era of the large complex financial institution was born.¹⁹¹

D. Can't Touch This: Sections 23A and 23B and the Rules of Separation Between Banks and FHC Affiliates

Sections 23A and 23B of the Federal Reserve Act restrict the interactions between commercial banks and their affiliates and subsidiaries.¹⁹² Section 23A¹⁹³ was enacted as part of the Banking Act of 1933¹⁹⁴ in order to protect federally insured depository institutions from excessive exposure to their riskier affiliates, and to prevent transfer of the federal subsidy to non-depository institutions.¹⁹⁵ Section 23B¹⁹⁶ was enacted in 1987 as part of the Competitive Equality Banking Act of 1987¹⁹⁷ to provide further protection in anticipation of the expanded securities powers being granted to banks and BHCs.¹⁹⁸

Both 23A and 23B define an affiliate as any company that controls the bank and any company that is controlled by such company.¹⁹⁹ Financial

186. Letter from Marc E. Lackritz, President, Sec. Indus. Ass'n, to William W. Wiles, Sec'y, Bd. of Governors of the Fed. Reserve Sys. (Sept. 30, 1996), *available at* <http://www.sifma.org/issues/item.aspx?id=461>.

187. *See* Press Release, Fed. Reserve, Announcing Conditional Approval of the Merger Between Travelers and Citigroup (Sept. 23, 1998), *available at* <http://www.federalreserve.gov/boarddocs/press/bhc/1998/19980923/19980923.pdf>.

188. *See* Daniel Parks, *Financial Services Overhaul Bill Clears After Final Skirmishing over Community Reinvestment*, 57 CONG. Q. WKLY. REP. 2654 (1999).

189. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

190. *Id.* § 101(a), 113 Stat. at 1341; FEIN, *supra* note 183, at 1-42.

191. *See* FEIN, *supra* note 183, at 1-43. Fein notes that much of the consolidation took place before the passage of the GLBA. *See id.* The GLBA is still notable, however, for removing any doubts as to the legality of LCFIs and providing an actual legal framework for them. *See id.*

192. The FRB has also issued Regulation W to help implement sections 23A and 23B. Regulation W also provides an array of specifics as to how these sections should operate. *See* 12 C.F.R. § 223 (2013).

193. 12 U.S.C. § 371c (2012).

194. Banking Act of 1933, Pub. L. No. 73-66, § 13, 48 Stat. 162, 183 (codified at 12 U.S.C. § 371c).

195. *See* Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683, 1686 (2011).

196. 12 U.S.C. § 371c-1.

197. Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 102, 101 Stat. 552, 564-66 (codified at 12 U.S.C. § 371c-1).

198. *See* FEIN, *supra* note 183, at 2-36.

199. 12 U.S.C. § 371c(b).

subsidiaries of the banks themselves also are considered affiliates.²⁰⁰ Sections 23A and 23B similarly define covered transactions²⁰¹ to include extending credit to an affiliate, purchasing or investing in the securities or derivatives of an affiliate, accepting the affiliate's securities as collateral for any extension of credit, and guaranteeing obligations of the affiliate.²⁰²

Under section 23A, all covered transactions must be on terms and conditions "consistent with safe and sound banking practices."²⁰³ Section 23A also places an overall limit of 20 percent on the total amount of credit a bank may extend to its affiliates²⁰⁴ and a 10 percent limit on credit extended to any specific affiliate.²⁰⁵ Extensions of credit are required to be secured by collateral according to a specific formula.²⁰⁶ Furthermore, section 23A also prohibits banks from purchasing certain low-quality assets from an affiliate.²⁰⁷

Section 23B provides a general requirement that all transactions with affiliates, including covered transactions, be at arms length.²⁰⁸ This means that the transaction must be on the same terms as the bank would require for a nonaffiliated company, at a similar time, in a similar transaction.²⁰⁹ If there is no comparable transaction, it must be on terms that in good faith would be offered to a nonaffiliated company.²¹⁰ Section 23B also imposes the arms length requirement on securities sales by a bank to an affiliate, payment of money or services to or from an affiliate, and any transactions between the bank and a third party in which the affiliate has a financial interest.²¹¹ Lastly, under section 23B, a bank is barred from publishing any advertisement or entering into an agreement suggesting that it is responsible for the obligations of affiliates.²¹²

The OCC, FRB, and FDIC all have statutory power to grant exemptions from section 23A to their respective institutions for a transaction.²¹³ The requirement for an exemption is that it be in the public interest and related to the purpose of section 23A.²¹⁴ The OCC and FRB are required to notify the FDIC before an exemption, and give it sixty days to object in writing if it finds the action presents a risk to the DIF.²¹⁵

200. *Id.* § 371c-1(d).

201. *See id.* §§ 371c(b)(7), 371c-1(b).

202. *See id.*; 12 C.F.R. § 223.3(h) (2013); *see also* CARPENTER & MURPHY, *supra* note 14, at 23.

203. 12 U.S.C. § 371c(a)(4).

204. *Id.* § 371c(a)(1)(B).

205. *Id.* § 371c(a)(1)(A).

206. *Id.* § 371c(c).

207. *Id.* § 371c(a)(3).

208. *Id.* § 371c-1.

209. *Id.* § 371c-1(a)(1)(A).

210. *Id.* § 371c-1(a)(1)(B).

211. *Id.* § 371c-1(a)(2).

212. *Id.* § 371c-1(c).

213. *Id.* § 371c(f).

214. *Id.*

215. *Id.* § 371c(f)(2).

II. GOVERNMENT-INSURED GAMBLING: THE PROBLEMS WITH DEPOSIT INSURANCE

As detailed in Part I, the U.S. scheme of federally sponsored deposit insurance was created with the goal of protecting depositors and creating stability in the banking system.²¹⁶ While a federally sponsored deposit insurance structure may help to achieve those goals, some of the negative consequences of such a system may also work to undermine them. This Part describes the problems created by having a federally sponsored system of deposit insurance. Part II.A discusses these problems generally, Part II.B offers specific examples from the recent past, and Part II.C examines whether the post-2008 financial crisis legislation has substantively improved any of these issues.

A. I Knew You Were Trouble When You Walked in: How Deposit Insurance Creates Moral Hazard and Economic Instability

The principal issue created by any insurance system is moral hazard.²¹⁷ Moral hazard can best be described as “[t]he tendency of an insured to relax his efforts to prevent the occurrence of the risk that he has insured against because he has shifted the risk to an insurance company.”²¹⁸ In the deposit insurance context, this means that depositors who are insured against loss are no longer concerned that a bank acting imprudently may lose its funds.²¹⁹ Accordingly, depositors are no longer incentivized to monitor their banks’ activities.²²⁰

This removes what would be two powerful restraints on a bank’s activities: bank runs and higher interest rates. Absent deposit insurance, if depositors believed a bank was taking excessively risky actions with their funds, they would either withdraw their funds (potentially initiating a bank run)²²¹ or demand higher interest rates.²²² But once deposit insurance makes depositor concerns irrelevant, banks no longer have to worry about bank runs²²³ and can raise funds from depositors at a substantially lower cost.²²⁴ This leaves banks free to assume more risk.²²⁵

216. See *supra* Part I.

217. See CARNELL ET AL., *supra* note 18, at 327 (describing all the issues insurance creates for private insurers because of moral hazard).

218. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 121 (5th ed. 1998).

219. See Carnell, *supra* note 88, at 319–21.

220. *Id.*

221. See Kaufman, *supra* note 30, at 23–24.

222. CARNELL ET AL., *supra* note 18, at 293.

223. See Kaufman, *supra* note 30, at 23–24.

224. See CARNELL ET AL., *supra* note 18, at 293; see also Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 977–79 (2009).

225. See CARNELL ET AL., *supra* note 18, at 293–94; see also Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 211 (2008).

The cost of that risk, which the bank would have borne itself through having to pay higher interest rates to depositors,²²⁶ is then shifted to DIF and the federal government that unequivocally backs it.²²⁷ In addition, deposit insurance, along with the other elements of the explicit federal safety net, allows banks to borrow funds at substantially lower interest rates.²²⁸ Thus, deposit insurance in the United States ultimately creates a federal subsidy that allows banks to access artificially cheap funds,²²⁹ which, again, can make it easier for banks to engage in higher levels of risk taking.²³⁰

The government attempts to restrain banks and LCFIs from taking advantage of this federal subsidy and from engaging in excessively risky activity through a variety of measures²³¹: (1) a system of regulatory oversight²³² and capital requirements to restrain banks' risk taking,²³³ (2) a system of risk-based premiums to attempt to shift the cost of risk from the DIF back to banks,²³⁴ and (3) sections 23A and 23B to prevent the spread of the subsidy to other nonbank financial institutions.²³⁵ However, history has demonstrated that these measures are often inadequate and ineffective,²³⁶ and continue to allow deposit insurance to provide an incentive for banks to engage in excessive risk taking. This risk taking, it has been argued, can in turn result in increased banking instability, increased likelihood of a banking crisis, and the increased likelihood of larger economic crisis.²³⁷

B. Memories of the Way We Were: Examples of Deposit Insurance's Negative Repercussions

Part II.B.1, II.B.2, and II.B.3 will give specific examples of the negative repercussions that deposit insurance has had on the financial system.

226. See CARNELL ET AL., *supra* note 18, at 293; see also Wilmarth, *supra* note 224, at 977–79.

227. See CARNELL ET AL., *supra* note 18, at 309.

228. See Arthur E. Wilmarth, Jr., *Narrow Banking: An Overdue Reform That Could Solve the Too-Big-To-Fail Problem and Align U.S. and U.K. Financial Regulation of Financial Conglomerates (Part II)*, BANKING & FIN. SERVICES POL'Y REP., Apr. 2012, at 1, 5.

229. See CARNELL ET AL., *supra* note 18, at 309.

230. See Schwarcz, *supra* note 225, at 211.

231. See Zachary J. Gubler, *Regulating in the Shadows: Systemic Moral Hazard and the Problem of the Twenty-First Century Bank Run*, 63 ALA. L. REV. 221, 233 (2012).

232. See Kam Hon Chu, *Deposit Insurance and Banking Stability*, 31 CATO J. 99, 105 (2011) (noting that deposit insurance, by removing depositors as monitors, creates the need for regulatory oversight).

233. See Gubler, *supra* note 231, at 233.

234. See *id.*

235. See Omarova, *supra* note 195, at 1687; Wilmarth, *supra* note 18, at 456.

236. See Gubler, *supra* note 231, at 233.

237. See Kam Hon Chu, *Deposit Insurance and Banking Crises in the Short and Long Run*, 23 CATO J. 265, 277 (2003) (concluding that deposit insurance does not make the occurrence of bank crises less likely in the long run, and may actually increase that likelihood).

1. Our House, with Two Cats in the Yard, and a Mortgage We Cannot Pay:
Nonprime Lending and Deposit Insurance

As an example of the ability of deposit insurance to encourage excessive risk taking and contribute to financial crisis, some commentators have pointed to its role in nonprime lending in the early 2000s. Nonprime home mortgages are inherently risky because they are offered to people with bad credit, who pose a greater risk of default and do not qualify for prime mortgages.²³⁸ Additionally, the risk of these mortgages increased over the course of the early 2000s as lending standards deteriorated.²³⁹ Despite this risk, the volume of nonprime mortgages grew from \$250 billion to \$1 trillion between 2001 and 2006.²⁴⁰ Nearly 10 million nonprime mortgages were originated between 2003 and mid-2007.²⁴¹ Furthermore, depository institutions and their subsidiaries and affiliates originated 79 percent of those.²⁴²

Banks kept originating these high-risk loans because they were making substantial profits from the loan fees and subsequent securitization.²⁴³ These profits were attainable because deposit insurance allowed banks to raise money cheaply to fund these loans regardless of their risk.²⁴⁴ Recognizing the advantages of this system, even securities firms that were not initially banks sought to acquire insured depository institutions.²⁴⁵ For example, in 2003, Merrill Lynch relied on FDIC-insured bank deposits to provide 51 percent of its funding for commercial and consumer loans.²⁴⁶

This boom in nonprime lending was ultimately catastrophic for the financial industry and the overall economy. Many analysts blame the 2008 financial crisis on the collapse of the housing market and the subsequent loss in value of the myriad financial products that based their value on that market.²⁴⁷ Much of the expansion in the housing market in the run-up to the crisis was driven by the growth in nonprime home mortgages.²⁴⁸ By 2009, commercial and investment banks had suffered more than \$910 billion in losses related to these loans and many required bailouts.²⁴⁹

238. See Wilmarth, *supra* note 224, at 1015–16.

239. See *id.* at 1020.

240. See *id.* at 970.

241. *Id.*

242. See *id.* at 1018–19.

243. See *id.* at 970–72.

244. See *id.* at 977–80.

245. *Id.*

246. See *id.* at 977 n.46.

247. See *id.* at 970.

248. See *id.* at 1015–16.

249. See *id.* at 1044.

2. Tell Me Have You Ever Really, Really Ever Loved a Derivative?:
How Deposit Insurance Encouraged Speculative
Derivatives Trading at Banks

Deposit insurance also played a role in helping banks grow their derivatives business in the lead-up to the 2008 financial crisis, providing another example of the ability of deposit insurance to contribute to financial crises. The OCC permits national banks to originate, deal, and trade in a wide variety of derivatives as part of the business of banking.²⁵⁰ Normally, a derivative is “simply a contract between two parties whose value is based on changes in an interest rate, currency, or almost anything else.”²⁵¹ The primary use of derivatives is to protect or hedge against loss from market risk.²⁵²

In the run-up to the 2008 financial crisis, banks were also permitted to use derivatives to incur risk when speculating on their own account.²⁵³ In addition, many of these were over-the-counter (OTC) and financial derivatives that could be tailored to mimic the risk and return profiles of fundamental securities like stocks and bonds, and thus were subject to the same types of risks as traditional securities.²⁵⁴ These derivatives were also subject to additional risks.²⁵⁵ They were more complex and harder to value than traditional securities,²⁵⁶ and subject to possible mass default if the price in the underlying asset suddenly changed.²⁵⁷ Additionally, many of these derivatives were highly leveraged, allowing them to create potential losses that far exceeded the holder’s investment.²⁵⁸

Despite these risks, in the run-up to the financial crisis, banks used OTC derivatives extensively to earn fees and generate profits through proprietary trading.²⁵⁹ “At the end of 2000, the seven most active bank dealers in the United States held derivatives with total notional values of more than \$38 trillion, seven times the volume they held in 1990,” and “OTC derivatives accounted for more than four-fifths of the derivative portfolios.”²⁶⁰ Big banks also dominated the derivatives trade, with seven of them holding approximately 96 percent of all derivatives held by U.S. banks in 2000.²⁶¹

250. COMPTROLLER OF THE CURRENCY, ACTIVITIES PERMISSIBLE FOR A NATIONAL BANK, CUMULATIVE 57 (2012), *available at* <http://www.occ.gov/publications/publications-by-type/other-publications-reports/bankact.pdf>.

251. DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 60 (2011).

252. *See* JAMES HAMILTON ET AL., A GUIDE TO FEDERAL REGULATION OF DERIVATIVES 110–11 (1998).

253. *See* FEIN, *supra* note 183, at SR-26; HAMILTON ET AL., *supra* note 252, at 111.

254. *See* Wilmarth, *supra* note 18, at 337–38.

255. *Id.* at 338.

256. *Id.* at 350.

257. *Id.* at 368.

258. *Id.*

259. *See id.* at 337.

260. *See id.* at 334–35.

261. *Id.* at 334.

Banks were largely able to grow and dominate this business because of the significant advantages they enjoyed from the implicit federal safety net and from deposit insurance.²⁶² First, whenever a bank failed in the past, regulators had always ensured its outstanding derivatives contracts were honored.²⁶³ In a complicated market like the one that exists for OTC derivatives,²⁶⁴ the expectation among investors that the default risk is less with banks is a substantial advantage.²⁶⁵ Second, as in the case of nonprime lending, deposit insurance provided banks access to low-cost funds they could utilize to engage in derivative trading, independent of the risks of those activities.²⁶⁶ This, in turn, allowed for higher profits from those activities.²⁶⁷ Thus, deposit insurance, in conjunction with the implicit safety net of bailouts, allowed banks to dominate and profit in the high-risk derivatives trade.²⁶⁸

In search of the increasing profits that derivatives could provide, banks in the years preceding the financial crisis increasingly pursued derivatives activities based on nonprime mortgages.²⁶⁹ As a result, banks became exposed to multiple layers of risk dependent on the performance of an already high-risk asset.²⁷⁰ Thus, when the housing bubble ultimately burst, the derivative activities of banks contributed to their incurrence of even greater losses.²⁷¹

3. All in All, It's Just Another Leak in the Wall: The Use of the Deposit Insurance Subsidy To Fund FHC Affiliates

Another example of the problems created by deposit insurance is the inability of the government to contain the federal subsidy to banks within FHCs. As discussed in Part I.E, the purposes of section 23A are to protect federally insured depository institutions from excessive exposure to their riskier affiliates, and to prevent the transfer of the federal subsidy to nondepository institutions.²⁷² The government also has wide discretion to waive section 23A's requirements for specific transactions.²⁷³ In her article *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, Professor Saule T. Omarova argues that the ineffective use of this authority has severely undermined section

262. *Id.* at 336–37, 372–73.

263. *See id.* at 373.

264. *See id.* at 336 (describing how the market for OTC derivatives is a difficult one for investors because they do not utilize standardized terms, are not traded on an organized market, and are not protected from default risks by clearinghouse guarantees).

265. *See id.* at 373.

266. *See Wilmarth, supra* note 10, at 1044–45.

267. *See Wilmarth, supra* note 18, at 337.

268. *See id.* at 373.

269. *See Wilmarth, supra* note 224, at 991–95, 1028–34.

270. *See id.* at 1034.

271. *See id.* at 1043–44.

272. *See Omarova, supra* note 195, at 1686.

273. *See id.* at 1699–1702.

23A's implementation, and allowed the federal subsidy to effectively subsidize the activities not just of banks but of LCFIs themselves.²⁷⁴

Professor Omarova offers a number of examples. She describes how, in the years leading up to the 2008 financial crisis, the FRB granted a number of waivers for LCFIs to reorganize their assets on the grounds that this would increase their efficiency and profitability.²⁷⁵ While the FRB continued to require that FDIC-insured banks not be saddled with low-quality assets (and when they were, required appropriate compensation to be given),²⁷⁶ Professor Omarova suggests the FRB did not understand the true purpose of the LCFIs' actions.²⁷⁷

Citing Citibank as an example, she describes how LCFIs used these waivers to place large amounts of nonprime mortgages that originated in uninsured affiliates within their FDIC-insured affiliates.²⁷⁸ By doing this, LCFIs could capitalize on the advantages that their FDIC-insured affiliates enjoyed in creating and selling derivatives based on these mortgages.²⁷⁹ Thus, these waivers essentially allowed LCFIs to saddle their FDIC-insured banks, and consequently the DIF, with increased risk so they could generate greater profits by utilizing the federal subsidy provided to their banks.²⁸⁰

In another example, Professor Omarova details how, in late 2007, when the securities market was hit by the shock of the subprime fallout, the FRB allowed several FDIC-insured banks to extend credit to their affiliated securities broker dealers.²⁸¹ "This was an extraordinary set of decisions,"²⁸² Professor Omarova writes. "Never before had the [FRB] removed the quantitative and qualitative requirements of section 23A, on such a massive scale, in order to prop up broader markets in distress."²⁸³ The FRB's actions allowed LCFIs to use the cheap federally subsidized funds of their bank subsidiaries to bail out their securities affiliates, who were suffering for their high-risk activities. This was exactly what section 23A had been designed to prevent.²⁸⁴

C. Don't Go Changing To Try and Please Me: How Dodd-Frank Did Little To Improve the Issues Associated with Deposit Insurance

After the financial crisis, the federal government initiated sweeping reforms of the banking and financial services industries through the passage of Dodd-Frank. Among other things, Dodd-Frank altered the calculation of

274. See *id.* at 1699–1703; see also Wilmarth, *supra* note 18, at 456 (describing how sometimes LCFIs simply ignore section 23A's requirements and are never discovered).

275. See *id.* at 1708–17.

276. See *id.* at 1704.

277. See *id.* at 1709.

278. See *id.*

279. See *id.* at 1716; see also *supra* notes 264–68 and accompanying text (describing in detail the advantages banks have in the derivatives market).

280. See Omarova, *supra* note 195, at 1716.

281. See *id.* at 1730.

282. See *id.* at 1732.

283. See *id.*

284. See *id.* at 1732–33.

FDIC premiums, increased banks' capital requirements,²⁸⁵ and prevented LCFIs from engaging in certain types of high-risk activities if they operated an FDIC-insured bank.²⁸⁶ However, it is unclear whether these changes will actually rectify the problems discussed in Part II.A and II.B. Dodd-Frank's goal was to eliminate the implicit safety net of federal bailouts created by the existence of TBTF LCFIs,²⁸⁷ and thus many of its changes reflect that objective and do not seek to correct issues with deposit insurance itself. Dodd-Frank also relies on regulatory strategies that have proved problematic in the past,²⁸⁸ and its bans on certain types of activities contain significant loopholes that may undermine their effectiveness.²⁸⁹

As described in Part I.A.5, Dodd-Frank altered the way the FDIC calculates its premiums. Proponents believe the new system is beneficial because it more accurately reflects risk.²⁹⁰ However, opponents have criticized the changes because they disproportionately impact larger banks,²⁹¹ ignoring the fact that smaller banks also played a significant role in fueling the 2008 financial crisis.²⁹²

Dodd-Frank and the Basel III regulations²⁹³ also required that the United States implement new rules for bank capital including increasing capital

285. See *infra* notes 294–304 and accompanying text.

286. See *infra* notes 301–02 and accompanying text.

287. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, pmbl., 124 Stat. 1376 (2010) (stating that the Act's purpose is "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', [sic] to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes").

288. See Gubler, *supra* note 231, at 239.

289. See *infra* notes 298–313 and accompanying text.

290. See Peter S. Kim, *The FDIC's Special Assessment: Basing Deposit Insurance on Assets Instead of Deposits*, 14 N.C. BANKING INST. 381, 389–97 (2010) (noting that basing assessments on assets instead of deposits penalizes larger banks, but may represent a better reflection of risk); Mark Gongloff & Min Zeng, *New Fee Shakes Up a Lending Market*, WALL ST. J. (Apr. 5, 2011, 12:01 AM), <http://online.wsj.com/article/SB20001424052748703712504576242542837822736.html> ("The new assessment was designed to better reflect the risks on individual banks' balance sheets by charging them for liabilities, including repo-market activities, instead of just their deposits.").

291. Calculating the assessment base using assets instead of deposits will disproportionately affect larger banks because the assets of these banks typically exceed deposits. See Kim, *supra* note 290, at 390–91.

292. See *id.* at 393.

293. The Basel Committee on Banking Supervision is a group of regulators from several countries that sets uniform international standards for banking regulation, most notably, capital requirements. See *Basel Committee on Banking Supervision*, BANK FOR INT'L SETTLEMENTS, <http://www.bis.org/bcbs/> (last visited Nov. 22, 2013). These standards are nonbinding and must be adopted individually by the member countries. See Narissa Lyngen, *Basel III: Dynamics of State Implementation*, 53 HARV. INT'L L.J. 519, 519–20 (2012). Previously, the Basel Committee issued global financial regulations through the Basel I and Basel II Accords, which were widely adopted by member countries. *Id.* In 2010, in response to the abuses that led to the financial crisis, the Basel Committee issued a new group of global financial regulations known as Basel III. *Id.* Many of these regulations require banks to hold more and higher quality capital, and have begun to be implemented in the United States by bank regulatory authorities. See Press Release, Fed. Reserve, Announcing

requirements and adjusting formulas.²⁹⁴ Again, the majority of these changes were aimed at forcing LCFIs to hold more capital in order to ameliorate the problem of TBTF.²⁹⁵ These reforms have also been criticized on the grounds that the failure of past capital requirements to restrain bank's risk taking casts doubt on whether these new rules will be any more effective than in the past.²⁹⁶

Dodd-Frank also adjusted the system of granting section 23A waivers by requiring notification to the FDIC and OCC of potential waivers, and giving those agencies an opportunity to object. However, Dodd-Frank did not make any changes to section 23A to deal with its complexity or the fact that banks deliberately violate its prohibitions.²⁹⁷ In addition, there is already evidence to suggest that the changes to the waiver system have been ineffective. In 2011, despite the FDIC's objection, the FRB allowed Bank of America (BOA) to move an undisclosed amount of its derivative financial instruments from its Merrill Lynch unit to its commercial banking subsidiary.²⁹⁸ This allowed BOA to avoid \$3.3 billion in collateral requirements by transferring the risk of those derivatives to the DIF and taking advantage of the FDIC-insured subsidiaries' higher credit rating.²⁹⁹

The provisions of Dodd-Frank that have the greatest potential to prevent banks from taking advantage of the explicit safety net of deposit insurance and moral hazard are the Volcker rule and the Lincoln Amendment. Section 619 of Dodd-Frank, popularly known as the Volcker rule, prohibits banks, their affiliates, and BHCs from engaging in proprietary trading.³⁰⁰ Proprietary trading occurs when banks buy and sell securities, derivatives, and other tradable assets for their own account.³⁰¹ More specifically, the bank uses its balance sheet, partly funded by government-insured deposits, to take speculative positions for its own profit.³⁰² Thus, the Volcker rule, by banning proprietary trading, seeks to prohibit banks and their affiliates from engaging in high-risk speculative activities.³⁰³ This means banks and their affiliates can no longer take advantage of moral hazard and government-subsidized funds to engage in those activities.

However, the Volcker rule contains a significant loophole, permitting banks to engage in "market making"—or the purchase and sale of securities

Approval of Final Rule To Ensure Banks Maintain Strong Capital Positions (July 2, 2013), available at <http://www.federalreserve.gov/newsevents/press/bcreg/20130702a.htm>.

294. See Press Release, *supra* note 293.

295. *Id.*

296. See Wilmarth, *supra* note 228, at 12–13.

297. Wilmarth, *supra* note 18, at 4.

298. Jonathan Weil, *Bank of America Bosses Find Friend in the Fed*: Jonathan Weil, BLOOMBERGBUSINESSWEEK (Oct. 19, 2011), <http://www.businessweek.com/news/2011-10-19/bank-of-america-bosses-find-friend-in-the-fed-jonathan-weil.html>.

299. See Wilmarth, *supra* note 228, at 4.

300. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620–31 (2010) (codified at 12 U.S.C. § 1851 (2012)).

301. See Wilmarth, *supra* note 10, at 1025.

302. See RAGHURAM G. RAJAN, FAULT LINES: HOW HIDDEN FRACTURES STILL THREATEN THE WORLD ECONOMY 173 (2010).

303. See Wilmarth, *supra* note 10, at 1026.

and other instruments on behalf of customers³⁰⁴—as well as risk-mitigating hedging activities.³⁰⁵ Distinguishing between banned proprietary trading and permitted market making is notoriously difficult, and could potentially make it easier for banks to evade the rule.³⁰⁶ Also, as the London Whale incident exemplifies, banks can still engage in highly speculative activities and make large profits in the name of hedging.³⁰⁷ Indeed, both regulators and JP Morgan agreed that the bank's actions did not violate the Volcker rule.³⁰⁸ Lastly, the Volcker rule can also be criticized on the grounds that it takes a flawed approach by only altering activities and not incentives, and therefore does little to actually prevent banks and FHCs from taking excessively damaging risks.³⁰⁹

The Lincoln Amendment forces FDIC-insured banks to spin off their derivative activities, only allowing them to use swaps, a type of derivative, for hedging or risk mitigating.³¹⁰ It also limits the type of swaps to those for interest rates, currency rates, and other activities permissible for a bank, and only allows credit default swaps that are cleared.³¹¹ Yet, the Lincoln Amendment also contains significant loopholes. It allows banks to continue trading and dealing in a variety of OTC and other derivatives that are not subject to Dodd-Frank's clearing requirement,³¹² and grandfathers swaps executed through July 2013.³¹³ Some commentators now estimate that the Lincoln Amendment will have little impact on the derivatives activities of banks and LCFIs.³¹⁴

III. YOU SAY YOU WANT A REAL SOLUTION: POSSIBILITIES FOR SOLVING THE PROBLEMS CREATED BY DEPOSIT INSURANCE

What Part II reveals is that there is significant evidence that the federally subsidized funds provided by deposit insurance helped contribute to the 2008 financial crisis. At the same time, Part II.C.3 raises a question as to whether the post-2008 reforms actually did anything to solve any of the

304. Dodd-Frank Wall Street Reform and Consumer Protection Act § 619, 124 Stat. at 1623–24 (codified as amended at 12 U.S.C. § 1851).

305. *Id.*

306. See Wilmarth, *supra* note 10, at 1029.

307. See Silver-Greenberg & Craig, *supra* note 3.

308. See Patterson, *supra* note 9.

309. RAJAN, *supra* note 302, at 173.

310. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 701–720, 124 Stat. 1376, 1641–58 (codified as amended at 15 U.S.C. §§ 8301–8325 (Supp. 2012)); see also Wilmarth, *supra* note 10, at 1033.

311. See Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 701–720, 124 Stat. at 1641–58 (codified as amended at 15 U.S.C. §§ 8301–8325); see also Wilmarth, *supra* note 10, at 1033.

312. See Wilmarth, *supra* note 10, at 1034.

313. See Steve Schaefer, *Dodd-Frank's Derivatives Curbs Won't Be a Problem for Big Banks*, *Fitch Says*, FORBES (June 5, 2012, 2:09 PM), <http://www.forbes.com/sites/steveschaefer/2012/06/05/dodd-franks-derivatives-curbs-wont-be-a-problem-for-big-banks-fitch-says/>.

314. *Id.*; see also Christine Harper & Bradley Keoun, *The New Rules Won't Stop the Next Crisis*, BLOOMBERG BUSINESSWEEK, July 5–11, 2010, at 42–43.

problems created by deposit insurance. Accordingly, Part III presents and examines a number of reforms that could improve the system of deposit insurance in the United States. The reforms can be broadly separated into three categories. Part III.A covers reforms to deposit insurance itself, Part III.B discusses reforms to capital requirements, and Part III.C discusses reforms to the organization of the entire financial services industry.

A. I Want It That Way: Reforms to the System of Deposit Insurance Itself

This Part examines those reforms that would solve the problems created by deposit insurance by making legal changes to the operation of deposit insurance itself. Part III.A.1 begins by discussing proposals to improve the FDIC's system of risk-based premiums. Then, Part III.A.2 analyzes reforming deposit insurance through the institution of other market-based reforms, including the possibility of eliminating federally sponsored deposit insurance.

1. I Like Risk-Based Premiums and I Cannot Lie: How Creating Better Risk-Based Premiums Can Solve the Problems of Deposit Insurance

Of all the ways to deal with the problems created by federally sponsored deposit insurance, one of the most obvious is to make adjustments to the system itself. As discussed in Part II, the FDIC currently charges a risk-based premium as part of its attempt to reduce the ability of banks to take advantage of the cheap federally subsidized funds provided by deposit insurance, thereby forcing them to internalize the cost of their risk.³¹⁵ As a result, improving this system of premium pricing so that it accurately reflects the risk of an institution is one way to mitigate the problems created by federally sponsored deposit insurance.

An improved system of risk-based pricing, which charges banks a premium that accurately represents their level of risk, would have a number of benefits. It would force banks to bear the cost of their own risk taking and would prevent underpriced insurance from distorting bank managers' incentives.³¹⁶ It would also reduce the incentive for risk taking generally by forcing banks to take risks commensurate with their returns.³¹⁷

Several reforms have been proposed to improve the premium system. One proposed reform is to charge premiums to banks and LCFIs at the holding company level.³¹⁸ The theory behind such a measure is that it would create higher payments for banks that are TBTF and would more

315. See *supra* notes 233–34 and accompanying text.

316. See CARNELL ET AL., *supra* note 18, at 328.

317. See Anna Kuzmik Walker, *Harnessing the Free Market: Reinsurance Models for FDIC Deposit Insurance Pricing*, 18 HARV. J.L. & PUB. POL'Y 735, 739 (1995).

318. See Scott E. Hein, Timothy W. Koch & Chrislain Nounamo, *Moving FDIC Insurance to an Asset-Based Assessment System: Evidence from the Special Assessment of 2009*, 64 J. ECON. & BUS. 24, 31–34 (2012); see also SHEILA BAIR, BULL BY THE HORNS 335 (2012) (arguing that the FDIC should be permitted to charge assessments to LCFIs themselves and not just insured banks).

accurately represent the cost of their failure.³¹⁹ Another possible reform would be to improve the FDIC premium formula itself. For example, Viral Acharya, João Santos, and Tanju Yorulmazer suggest that new factors should be added to the risk-based premium formula.³²⁰

Yet another potential reform would be to allow the market to determine appropriate premium pricing, instead of the FDIC. One way to obtain this market pricing is through reinsurance.³²¹ A reinsurance scheme in the United States could take a variety of forms,³²² but it would essentially make a third party responsible for a portion of the loss the FDIC would experience in a bank failure.³²³ The value of this reinsurance is not the actual insurance it would provide against loss, but instead the market information it would provide on the appropriate cost for risk.³²⁴ The FDIC could then use this data directly to formulate a more accurate risk-based premium. Alternatively, the FDIC could pass the cost of reinsurance directly on to a bank, resulting in an additional payment for the bank that is based on the market's assessment of its risk, essentially a more accurate risk-based premium.³²⁵

Utilizing the markets to create risk-based premiums has clear benefits. Regulatory agencies like the FDIC inherently struggle to create accurate risk-based premiums because they are not subject to market discipline, lack experience, and are vulnerable to political pressure and industry lobbying.³²⁶ However, a reinsurance model may also struggle to provide accurate risk-based premiums for two reasons. First, firms entering the deposit reinsurance market will, in the short run, lack the data and experience to create effective premiums.³²⁷ Second, the accuracy of pricing may be negatively impacted by the expectation that regulators and the government will step in to save a bank that is TBTF.³²⁸

Overall, this underscores the larger problem with creating better risk-based premiums: it is easier said than done. Accurately calculating and assessing risk is difficult, and thus so is creating a better system of calculating premiums.³²⁹ Additionally, even if the FDIC had access to market-based information from reinsurance, it may still be difficult to create

319. See Hein, Koch & Nounamo, *supra* note 318, at 31–34.

320. Acharya, Santos & Yorulmazer, *supra* note 86, at 97. Specifically, they suggest adding metrics that account for systemic risk and the factors that cause it, such as bank interconnectedness and the costs of resolution. See *id.*

321. See Walker, *supra* note 317, at 739.

322. See *id.* at 744–55.

323. See *id.* at 741.

324. See *id.* at 740.

325. See *id.* at 740–41.

326. See *id.* at 739–40.

327. See *id.* at 775–77 (noting that, regardless of initial difficulties, “the private sector’s greater incentive to correlate risk and price, even with facility merely equal to the public sector, will lead to improvements over the current FDIC pricing system”).

328. See *id.* at 789.

329. See CARNELL ET AL., *supra* note 18, at 329; Acharya, Santos & Yorulmazer, *supra* note 86, at 90.

a more accurate risk-based formula.³³⁰ Thus, creating a more accurate risk-based premium may be desirable to reduce the subsidy that deposit insurance gives to banks, but it may not be accomplishable.³³¹

2. Living La Vida Free Market: Reducing the Subsidy by Eliminating It: Expanded Coinsurance or Ending Deposit Insurance

Another possible way to fix the system of deposit insurance is to reduce the level of coverage. More specifically, the government could expand the use of coinsurance or eliminate federally sponsored deposit insurance entirely. A system of expanded coinsurance would limit the availability of deposit insurance by either lowering the overall insured amount, or making some percentage less than 100 percent of the insured amount available to depositors in the event of a bank failure.³³² In fact, the original deposit insurance plan, outlined in the Banking Act of 1933, contemplated such a scheme. It provided 100 percent protection of the first \$10,000 of each depositor, 75 percent coverage of the next \$40,000 of deposits, and 50 percent coverage of all deposits in excess of \$50,000.³³³ Currently, depositors with deposits up to \$250,000 are subject to no coinsurance, as their deposits are 100 percent insured.³³⁴

The other possibility is to discontinue federally sponsored deposit insurance. However, this does not necessarily mean that depositors would be left unprotected. Depositors could safely invest their savings in money market funds invested in Treasury bills or highly rated commercial paper.³³⁵ In addition, as Charles Calomiris suggests, banks could operate insurance programs among themselves, and the government could regulate these insurance programs.³³⁶

The benefit of limiting or eliminating deposit insurance is that it would prevent moral hazard by incentivizing depositors to monitor banks' activities.³³⁷ Depositors would then demand higher interest rates to place

330. See Walker, *supra* note 317, at 785–89.

331. See Yuk-Shee Chan, Stuart I. Greenbaum & Anjan V. Thakor, *Is Fairly Priced Deposit Insurance Possible?*, 47 J. FIN. 227, 243 (1992) (concluding perfectly priced deposit insurance is impossible); see also Thomas L. Hogan & William J. Luther, *Explicit and Implicit Costs of Government Provided Deposit Insurance* (June 13, 2012) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2083662 (concluding that accurately fair deposit insurance pricing is impossible because of outside costs).

332. See Lawrence J. White, *The Reform of Federal Deposit Insurance*, 3 J. ECON. PERSP. 11, 22 (1989).

333. See *supra* notes 61–66 and accompanying text.

334. See *supra* Part I.A.

335. See RAJAN, *supra* note 302, at 179.

336. See Calomiris, *supra* note 32, at 295.

337. White, *supra* note 332, at 22; see also Edward J. Kane & Robert Hendershott, *The Federal Deposit Insurance Fund That Didn't Put a Bite on U.S. Taxpayers*, 20 J. BANKING & FIN. 1305, 1325 (1996) (noting that coinsurance helps contain moral hazard and enhance market discipline).

their money in banks that engage in risky activities.³³⁸ The result would be greater market discipline.³³⁹ Banks would lose the federal subsidy that allows them to raise cheap funds,³⁴⁰ making certain high-risk activities less profitable. Similarly, a renewed fear of bank runs would incentivize banks to avoid excessive risk.³⁴¹

However, there are several potential problems created by reducing or eliminating deposit insurance. First, depositors may not be capable of fulfilling the monitoring role that this system requires to function effectively.³⁴² They may lack the time, inclination, or skill to evaluate the safety of their banks.³⁴³ Second, such a system may leave unsophisticated depositors vulnerable to losing their entire life savings.³⁴⁴ Lastly, a system of depositor monitoring may detract from overall economic stability. Depositors' reliance on imperfect information could initiate panicked mass withdrawals, closing perfectly healthy banks and possibly initiating an overall economic crisis.³⁴⁵

Reducing or eliminating deposit insurance therefore presents a difficult choice.³⁴⁶ Limiting or removing deposit insurance may create harmful bank runs and system fragility, but could incentivize banks to avoid high-risk activity.³⁴⁷ Conversely, keeping deposit insurance at its current level eliminates bank runs and provides stability, but will decrease market discipline.³⁴⁸ However, the scale between these competing choices may be tipped towards the side of reducing coverage if one finds deposit insurance fails to provide its stated benefits.

There is growing evidence that deposit insurance may not prevent bank runs or contribute to economic stability. For example, one study recently concluded that deposit insurance is only partially effective in preventing bank runs, and that instead stronger and longer relationships between depositors and their banks may be more effective.³⁴⁹ In fact, other countries have still experienced bank runs despite having deposit insurance systems.³⁵⁰ Similarly, other researchers have presented evidence that not

338. Alison M. Hashmall, *After the Fall: A New Framework To Regulate "Too Big To Fail" Non-bank Financial Institutions*, 85 N.Y.U. L. REV. 829, 840 (2010).

339. *See id.* at 840.

340. RAJAN, *supra* note 302, at 178–79.

341. *See* Gubler, *supra* note 231, at 232–33.

342. *See* White, *supra* note 332, at 22 (noting that depositors are not likely to be the best-equipped group to carry out bank monitoring).

343. *See* Coppola, *supra* note 31, at 439.

344. *See* RAJAN, *supra* note 302, at 179 (describing how deposit insurance was intended to protect household savings). *But see* CARNELL ET AL., *supra* note 18, at 331 (noting that coinsurance would protect depositors but would also allow for some of the benefits of increased shareholder discipline).

345. *See* Chu, *supra* note 232, at 101; White, *supra* note 332, at 23; *see also* Kaufman, *supra* note 30, at 27–28.

346. *See* Gubler, *supra* note 231, at 233.

347. *Id.*

348. *Id.*

349. *See* Chu, *supra* note 232, at 101.

350. *See id.* at 105; *see also* RAJAN, *supra* note 302, at 179–80. Results like this may be unsurprising considering a study in the Netherlands that revealed depositors knew little about

only does deposit insurance fail to create economic stability, but instead leads to instability over the long term.³⁵¹

Yet, even if empirical research demonstrates that federally sponsored deposit insurance does not provide its promised benefits, reducing or eliminating it may still not be a viable reform. Whether people understand it or not, deposit insurance enjoys substantial support from the public.³⁵² Accordingly, politicians would be unlikely to support its shrinking or elimination, and a reform of this type may be impossible.³⁵³

B. Hold on for One More Day: Improving Capital Requirements

As mentioned briefly in Part II, capital requirements are one way in which the United States attempts to contain the problems created by having a deposit insurance system.³⁵⁴ Banks can finance their purchase of assets through capital/equity or debt (an example of which is deposits).³⁵⁵ Absent deposit insurance, banks would be limited in their ability to finance asset purchases through debt/deposits because as they used more debt, debt holders and depositors would demand higher interest rates.³⁵⁶ However, deposit insurance prevents depositors from demanding higher interest rates, removes that limitation, and does so at cost to the government.³⁵⁷ Capital requirements force banks to support their operations and asset purchases with certain amounts of equity,³⁵⁸ and thereby try to correct this issue.³⁵⁹ Thus, they reduce the ability of banks to take advantage of deposits as cheap federally subsidized funds.

Furthermore, capital requirements reduce the likelihood that banks will fail. By ensuring that banks have a certain amount of resources on hand, capital requirements seek to ensure that banks remain solvent in times of

their deposit insurance coverage. See Michiel Bijlsma & Karen van der Wiel, *Consumer Protection of Deposit Insurance: Little Awareness, Limited Effectiveness?* 22 (Tilburg Law and Economics Center, Discussion Paper No. 2012-013, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2034186 (finding that Dutch depositors lacked detailed knowledge and trust in their deposit system).

351. See Chu, *supra* note 237, at 277 (concluding that deposit insurance does not make the occurrence of bank crises less likely in the long run, and may actually increase that likelihood); Chu, *supra* note 232, at 110 (finding that low coverage schemes are more likely to have no banking crises); see also Kaufman, *supra* note 30, at 22 (noting that before the advent of the explicit safety net and deposit insurance, banks in the United States actually held higher capital ratios, assumed less risks, and failed slightly less than nonbank firms).

352. See CARNELL ET AL., *supra* note 18, at 331 (describing how limiting deposit insurance is “beyond the political pale”).

353. See *id.*; see also Kaufman, *supra* note 30, at 28 (assuming that government provided deposit insurance, in some form, is a political fact of life).

354. See *supra* Part II.A.

355. See George J. Benston, *The Purpose of Capital for Institutions with Government-Insured Deposits*, 5 J. FIN. SERVICES RES. 369, 373–74 (1992).

356. *Id.*

357. See *supra* Part II.

358. Joseph Jude Norton, *Capital Adequacy Standards: A Legitimate Regulatory Control for Prudential Supervision of Banking Activities?*, 49 OHIO ST. L.J. 1299, 1313 (1989).

359. See Gubler, *supra* note 231, at 234.

economic turmoil.³⁶⁰ This reduces both the risk to the DIF³⁶¹ and the possibility that a bailout will be necessary.³⁶²

Lastly, capital requirements also have an impact on bank managers' incentives to engage in certain activities. Capital requirements force bank owners and managers to have more of their own money at risk.³⁶³ This reduces their incentive to engage in high-risk and potentially harmful activities, including those that could exacerbate the problems at an already troubled bank.³⁶⁴ In addition, it imposes an additional market test on bank managers. While they may not have to convince depositors that their institution is safe, they will need to convince investors in order to continue the bank's operations in that particular activity.³⁶⁵

Because of these benefits, both Dodd-Frank and Basel III sought to improve and increase banks' capital requirements.³⁶⁶ Additionally, several other proposals have recommended increasing capital requirements even further. The one most likely to become law is a regulation jointly proposed by the FDIC, OCC, and FRB in July of 2013.³⁶⁷ The proposed regulation calls for the eight largest LCFIs³⁶⁸ in the United States to hold greater levels of capital at both the holding company level and in their FDIC-insured subsidiary banks.³⁶⁹ Meanwhile, Senators David Vitter and Sherrod Brown have proposed an even more aggressive approach.³⁷⁰ Their bill would require LCFIs to increase their equity capital to 15 percent of assets, but is unlikely to pass.³⁷¹

Merely increasing capital requirements, however, may not be enough to contain the risk taking of banks and LCFIs when supported by federally subsidized funds. First, capital is a lagging indicator of problems, and may

360. See Carnell, *supra* note 88, at 357; see also Benston, *supra* note 355, at 374. But see Norton, *supra* note 358, at 1351 (arguing that capital is never adequate in a worst case scenario at a poorly run institution).

361. See Carnell, *supra* note 88, at 357.

362. See Lyngen, *supra* note 293, at 523.

363. See Carnell, *supra* note 88, at 357; see also Benston, *supra* note 355, at 374 (describing how capital requirements initiate the oversight of nongovernmental actors).

364. See Carnell, *supra* note 88, at 320–21; see also Benston, *supra* note 355, at 375; Norton, *supra* note 358, at 1355 (describing how capital requirements force managers to make better plans for their banks).

365. See Carnell, *supra* note 88, at 357.

366. See *supra* notes 294–95 and accompanying text.

367. *The Triumph of Low Expectations*, *ECONOMIST*, July 20, 2013, at 61, 61–62.

368. BOA, BNY Mellon, Citigroup, Goldman Sachs, JP Morgan, Morgan Stanley, State Street, and Wells Fargo. See *id.* This again demonstrates that many of the financial regulations enacted since 2008 have been aimed at LCFIs with the goal of ending TBTF. See Halah Touryalai, *Big Banks Warn Regulators: Tougher Capital Rules Will Hurt Everyone*, *FORBES* (July 9, 2013, 4:25 PM), <http://www.forbes.com/sites/halahtouryalai/2013/07/09/big-banks-warn-regulators-tougher-capital-rules-will-hurt-everyone/>.

369. See Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions, 78 Fed. Reg. 51,101 (Aug. 20, 2013). This includes a 5 percent leverage ratio at the holding company level and a 6 percent level at the subsidiary FDIC-insured bank. See *Triumph of Low Expectations*, *supra* note 367, at 61.

370. Too Big To Fail Act, S. 798, 113th Cong. (2013).

371. See *The Triumph of Low Expectations*, *supra* note 367, at 62.

not accurately demonstrate that a bank is engaged in troubling activity.³⁷² Indeed, a bank may appear capitalized on paper but still be heading for insolvency.³⁷³ Second, the amount and quality of capital is difficult to calculate.³⁷⁴ Judging an asset's value is inherently difficult due to general problems with accounting principles, the ability of banks to delay the recognition of losses in financial reports, and the inability of regulators to accurately calculate the value of assets themselves.³⁷⁵

Lastly, higher capital requirements may have negative economic implications of their own. Higher capital requirements can restrain a bank's profitability and growth capabilities.³⁷⁶ Analysts have already predicted that the regulation proposed by the FDIC, OCC, and FRB will further dilute banks' returns,³⁷⁷ could cause banks to leave certain industries, and may limit the availability of credit in the United States.³⁷⁸ However, other analysts have challenged these assertions, citing how profitable banks have been since the imposition of new regulations after 2008.³⁷⁹ In the case of the more aggressive bill proposed by Senators Vitter and Brown, the loss of profit would have an even more substantial effect—it would likely cause the largest LCFIs to break up.³⁸⁰

C. You Came in Like a Wrecking Ball: Reforms to the Organization of the Entire Financial Services Industry

Part III.C analyzes proposed reforms that would ameliorate the problems created by deposit insurance by reforming the structure of the entire financial system. Part III.C.1 discusses proposals that seek to separate commercial banks from investment banks, prevent the affiliations that allow for the existence of LCFIs, and essentially reenact the GSA. Part III.C.2 reviews proposals that would severely limit the types of financial activities that insured depository institutions could engage in, but that, in many cases, would not limit their ability to affiliate with other financial firms and form LCFIs.

1. Party in the GSA: A Return to Glass-Steagall-Type Prohibitions

While the ultimate effect of the legislation proposed by Senators Vitter and Brown may be the breaking up of LCFIs, others have proposed a more

372. See Carnell, *supra* note 88, at 337.

373. See *id.* at 351.

374. See Norton, *supra* note 358, at 1361.

375. See Carnell, *supra* note 88, at 351. Basel III did attempt to solve some of these problems, as demonstrated by the implementing regulations promulgated in the United States. See Press Release, *supra* note 293. However, past Basel accords, regardless of their reforms, have proved to be ineffective at preventing financial crisis. See Lyngen, *supra* note 293, at 526.

376. See Norton, *supra* note 358, at 1313.

377. See *Triumph of Low Expectations*, *supra* note 367, at 61–62.

378. Peter Eavis, *Rising Bank Profits Tempt a Push for Tougher Rules*, N.Y. TIMES, Apr. 18, 2013, at B8.

379. *Id.*

380. *Id.*

direct approach. In an effort to fix the problems created by section 23A (and prevent LCFIs from using the cheap federally subsidized funds in their FDIC-insured subsidiaries to fund activities in other riskier subsidiaries),³⁸¹ several legislators have proposed reinstating the GSA.³⁸² These proposals all differ somewhat in their details, yet they all would prevent FDIC-insured banks from affiliating with securities firms and would inevitably shrink LCFIs and FHCs.³⁸³

Proponents of reinstating the GSA³⁸⁴ argue it would have two benefits. First, fully separating commercial banks from other more speculative institutions is a simpler system to administer. It would be substantially more straightforward than the Volcker rule,³⁸⁵ and given that affiliate transactions are difficult to police, preventing affiliation would ensure that the federal subsidy would not spread.³⁸⁶ Second, it would promote macroeconomic stability. By separating banking institutions that are essential to the economy from the risky endeavors of more speculative affiliates, stability is increased by limiting banks' exposure to risk.³⁸⁷ To support this theory, proponents like Senator Elizabeth Warren have cited to history, noting how the combination of deposit insurance, strict GSA prohibitions, and SEC regulations provided fifty years of financial stability before the GSA was impacted by deregulation.³⁸⁸

However, opponents of reinstating the GSA have questioned whether the GSA actually contributed to macroeconomic stability when it was in effect. Several studies have concluded that the activities the GSA was intended to prevent (securities activities by commercial banks) had no impact on causing the Great Depression.³⁸⁹ Opponents instead claim that GSA's

381. See *supra* notes 272–84 and accompanying text.

382. See The 21st Century Glass-Steagall Act, S. 1282, 113th Cong. (2013); Glass-Steagall Restoration Act, H.R. 2451, 112th Cong. (2011); Return to Prudent Banking Act, H.R. 1489, 112th Cong. (2011); Banking Integrity Act, S. 2886, 111th Cong. (2009).

383. Alison Vekshin & James Sterngold, *War on Wall Street As Congress Sees Returning to Glass-Steagall*, BLOOMBERG (Dec. 27, 2009, 7:01 PM), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aeQNTmo2vHpo>.

384. Even Sandy Weill, the former CEO of Citigroup, whose acquisition of Travelers Insurance helped facilitate the GSA's demise, declared on CNBC in the summer of 2012 that GSA-type prohibitions should be brought back. *Wall Street Legend Sandy Weill: Break Up the Big Banks*, CNBC (July 25, 2012, 8:02 AM), <http://www.cnbc.com/id/48315170>.

385. Ezra Klein, *Elizabeth Warren: "That's the Strongest Argument for a Modern Glass-Steagall"*, WASH. POST (May 14, 2012, 3:19 PM), http://www.washingtonpost.com/blogs/ezra-klein/post/elizabeth-warren-thats-the-strongest-argument-for-a-modern-glass-steagall/2012/05/14/gIQAfXtLPU_blog.html.

386. See Omarova, *supra* note 195, at 1774–75.

387. *Id.*; see also Joseph E. Stiglitz, *Capitalist Fools*, VANITY FAIR, Jan. 2009, at 48 (arguing that the repeal of the GSA transformed the financial culture to one where excessive risks were acceptable and reinstating it could change that).

388. *The Daily Show with Jon Stewart* (Comedy Central television broadcast Apr. 15, 2009), available at <http://www.thedailyshow.com/watch/wed-april-15-2009/elizabeth-warren-pt-2> (interviewing Elizabeth Warren, who argued that the effectiveness of Glass-Steagall is demonstrated by the fifty years of economic stability it provided).

389. See FEIN, *supra* note 183, at 4–4 to –6. But see Wilmarth, *supra* note 175, at 611–15 (describing how allowing banks to engage in securities activities contributed to the banking and economic crisis of the 1930s).

separation of commercial banks from investment banks reflected the views of key politicians and not what was empirically beneficial to the economy.³⁹⁰ To the extent that the GSA had any positive impact at all, opponents argue that it only did so because the United States was entrenched in such a serious financial crisis that bold moves were the only way to bring back public confidence.³⁹¹

Opponents also argue that reinstating the GSA would hurt bank profits and have a negative effect on the overall economy. Banks have consistently insisted that their size, ability to affiliate, and ability to engage in an expanded range of activities allows them to be more profitable.³⁹² This was part of the justification for ending the GSA in the first place.³⁹³ Thus, opponents argue that reenacting the GSA, and forcing LCFIs to separate, may make banks less profitable and create some measure of economic harm.³⁹⁴

Overall, even if the GSA was reenacted, there is nothing to guarantee that, like the original GSA, it would not be subject to the same slow erosion as the turmoil of the 2008 financial crisis fades into memory.³⁹⁵ Additionally, while the goal of reinstating the GSA is to create macroeconomic stability, it seeks to do so by breaking up LCFIs and ending the implicit safety net of TBTF.³⁹⁶ It would do little to prevent insured banks themselves from continuing to take advantage of deposit insurance to engage in many of the highly speculative activities, including derivatives trading, that are permitted as part of the business of banking.³⁹⁷

2. I Would Do Anything for Profit, but I Can't Do That: Narrow Banking and Only Allowing Banking at a Bank

Another approach that would involve substantial legal changes to the entire financial services industry would be instituting a system of narrow banking. Broadly speaking, in a system of narrow banking, FDIC-insured banks would only be permitted to hold deposits and invest in safe assets.³⁹⁸ Under Professor Arthur Wilmarth's narrow-banking proposal, there would be two tiers of narrow banks.³⁹⁹ First-tier narrow banks would be those that

390. See FEIN, *supra* note 183, at 4-4 to -6.

391. *Id.*

392. See Wilmarth, *supra* note 18, at 223.

393. See Presidential Statement on Signing the Gramm-Leach-Bliley Act, 35 WEEKLY COMP. PRES. DOC. 2363-66 (Nov. 12, 1999).

394. Vekshin & Sterngold, *supra* note 383.

395. See *supra* Part I.C (describing how the GSA's prohibitions were eroded by regulators and courts over several decades).

396. Press Release, Elizabeth Warren, U.S. Senator, Senators Warren, McCain, Cantwell, and King Introduce 21st Century Glass-Steagall Act (July 11, 2013), available at http://www.warren.senate.gov/?p=press_release&id=178.

397. See *supra* Part II.B. A number of proposed bills attempting to reenact the GSA also include bans on proprietary trading. This would restrain many of the speculative activities that banks engage in.

398. See Gubler, *supra* note 231, at 267. Safe assets can be defined in a number of ways. See *id.*; see also CARNELL ET AL., *supra* note 18, at 333.

399. Wilmarth, *supra* note 228, at 7.

were not part of a financial holding company, mostly small community banks.⁴⁰⁰ These banks would be permitted to take deposits and engage in a broad range of other banking-related services.⁴⁰¹ They would have the ability to purchase derivatives as end users, but only to hedge against risk.⁴⁰² Second-tier narrow banks would be those FDIC-insured banks that are affiliated with FHCs, and would consist of the United States' largest banking organizations.⁴⁰³ These banks would be permitted to take deposits, but would hold all of their assets as short-term securities that could be marked to market, and would essentially operate as money market mutual funds.⁴⁰⁴ These banks would be prohibited from extending any credit or transferring any funds to their FHC affiliates.⁴⁰⁵ Also, like the first-tier narrow banks, these banks would be prohibited from dealing in derivatives, except to purchase them as end users to hedge against risk.⁴⁰⁶

Sheila Bair, the former chairman of the FDIC, has advocated for a similar system. In her book *Bull by the Horns*, she proposes that insured depository institutions that are subsidiaries of LCFIs should only be used to support traditional banking operations.⁴⁰⁷ She would then require that all nontraditional banking activities be conducted in other LCFI affiliates that are not in any way supported by insured deposits.⁴⁰⁸

The overall result is that narrow banking would force LCFIs to rely on uninsured debt and equity rather than on less expensive federally insured deposits.⁴⁰⁹ Proponents argue that this would ensure that LCFIs cannot exploit the federal subsidy to engage in speculative activities either within their banks or affiliated financial entities,⁴¹⁰ and would force LCFIs and banks to prove that their speculative activities actually provided worthwhile returns.⁴¹¹ Ultimately, if the LCFIs that relied on these activities could not prove their profitability, they would be forced to break up, and in turn, also reduce the implicit subsidy created by TBTF.⁴¹²

The primary problem with narrow banking is that it may have adverse economic effects. Narrow banks may make credit less available for individuals and businesses, as banks may become less willing to originate and hold illiquid assets.⁴¹³ Also, narrow banking, by restricting a bank to

400. *Id.* at 2.

401. *Id.*

402. *Id.*

403. *Id.*

404. *Id.* at 2–3.

405. *Id.*

406. *Id.*

407. *See* BAIR, *supra* note 318, at 329–30.

408. *See id.*

409. *See id.*; *see also* ROBERT E. LITAN, WHAT SHOULD BANKS DO? 178 (1987).

410. *See* LITAN, *supra* note 409, at 178.

411. *See* BAIR, *supra* note 318, at 329–30; Wilmarth, *supra* note 228, at 5–6; *see also* LITAN, *supra* note 409, at 178.

412. *See* LITAN, *supra* note 409, at 178.

413. *See* CARNELL ET AL., *supra* note 18, at 333. *But see* Wilmarth, *supra* note 228, at 6 (arguing that his plan, by allowing first-tier narrow banks to still lend commercial loans, would mitigate this problem).

holding safe assets, would reduce its rate of return and shrink its net income.⁴¹⁴ Lastly, the other problem with narrow banking is that it would be a radical change.⁴¹⁵ It would drastically alter the way that banks operate in the economy and in society,⁴¹⁶ and this may make it politically impossible.

IV. WHERE DO WE GO FROM HERE?: CREATING A MODERN DEPOSIT INSURANCE FRAMEWORK TO PROMOTE ECONOMIC STABILITY AND PROTECT DEPOSITORS

Ultimately, the reforms that this Note advocates for are those that acknowledge the realities of the modern financial system in the United States and deal with the problems created by deposit insurance by relying on the power of the free market. Part IV.A discusses why such reforms are preferable. Part IV.B then articulates the specific reforms to the law that this Note advocates.

A. *Don't Stop Believing: Why Market-Oriented Reforms Should Be Enacted To Solve the Problems Created by Deposit Insurance*

In the aftermath of the 2008 financial crisis, and the bailouts of LCFIs that came with it, the public and politicians understandably expressed a desire to end the implicit subsidy provided by TBTF that motivated LCFIs to take the excessive risks that ultimately wrecked the economy.⁴¹⁷ Since then, Dodd-Frank, the regulations promulgated in its wake, and several other proposals to fix the U.S. financial system have all focused on that goal.⁴¹⁸ However, if the problem with the implicit safety net of TBTF is that it gives LCFIs the incentive to engage in highly speculative activities, then the problem with deposit insurance and the explicit safety net is that it gives LCFIs the cheap funds to help make those speculative activities profitable.⁴¹⁹ Thus, this Note advocates first and foremost for reforms that equally address that issue as much as TBTF.

In many ways, the operation of federally sponsored deposit insurance in the United States represents an antiquated system. Founded in 1933, the FDIC was established during a much different time where the GSA prevented banks from being affiliated with securities firms,⁴²⁰ the business of banking did not include complex derivatives,⁴²¹ the LCFIs that dominate today's financial landscape did not exist,⁴²² and indeed, the financial industry itself was much simpler. The United States has taken some strides

414. R. Alton Gilbert, *A Comparison of Proposals To Restructure the U.S. Financial System*, FED. RES. BANK ST. LOUIS REV., July/August 1988, 58, 74–75.

415. See CARNELL ET AL., *supra* note 18, at 333.

416. See *id.*

417. See *supra* note 104 and accompanying text.

418. See *supra* note 104 and accompanying text.

419. See *supra* Part II.A–B and accompanying text.

420. See *supra* note 172 and accompanying text.

421. See *supra* note 182 and accompanying text.

422. See *supra* notes 172–76 and accompanying text.

to adjust deposit insurance and financial regulation to the realities of modern times, including implementing risk-based premiums, requiring least cost resolution methods,⁴²³ and giving the FDIC the power of the OLA to take over and resolve failing LCFIs.⁴²⁴

However, even recent reforms to the system of financial regulation seem to have done little to limit LCFIs from engaging in speculative activity and taking advantage of the cheap federally subsidized funds provided by deposit insurance.⁴²⁵ Section 23A remains difficult to enforce. Its waiver system is seemingly still vulnerable, and thus it is largely ineffective in preventing LCFIs from taking advantage of insured deposits to support the activities of nonbank affiliates.⁴²⁶ The Lincoln Amendment will change little of what insured depository institutions are permitted to do with derivatives.⁴²⁷ The Volcker rule, with many of its implementing regulations still unfinished as of this writing, is still unlikely to stop banks from gambling with insured deposits and turning a profit, while nominally calling it hedging risk, as exemplified by the London Whale incident.⁴²⁸

What, then, is the answer? Many believe that reenacting the GSA or significantly raising capital requirements would help prevent LCFIs from engaging in high-risk activities and utilizing federally subsidized deposits.⁴²⁹ But such reforms are not without cost.⁴³⁰ While banks have demonstrated an ability to remain profitable in the wake of all the regulations passed since 2008, their warnings of a potential loss in profits may not just be exaggeration.⁴³¹ Whether they are politically popular or not, banks and LCFIs are integral parts of the nation's economy.⁴³² Cutting back their profits too much, even in the name of protecting the financial system and creating a more stable economy, would, in the long run, benefit no one.

As an alternative, this Note advocates for letting the market decide what activities are most profitable for LCFIs. No longer should federally subsidized funds support highly speculative activities by allowing them to be profitable. No longer should regulators debate what activities LCFIs should or should not be engaged in. Thinking logically, the easiest way to eliminate the federal subsidy provided by deposit insurance and increase market discipline would be to eliminate deposit insurance, but there are many reasons this is an unacceptable choice politically, socially, and economically.⁴³³ Instead, this Note advocates for several reforms that should be made to decrease the federal subsidy provided by deposit

423. *See supra* notes 86–87 and accompanying text.

424. *See supra* notes 114–29 and accompanying text.

425. *See supra* Part II.

426. *See supra* Part II.B.3.

427. *See supra* notes 312–14 and accompanying text.

428. *See supra* notes 304–07 and accompanying text.

429. *See supra* notes 358–65, 387–88.

430. *See supra* notes 376–77, 392–94 and accompanying text.

431. *See* Eavis, *supra* note 378.

432. *See id.* (describing the negative broader economic effects of overregulating banks).

433. *See supra* Part III.A.2 and accompanying text.

insurance and increase market discipline on banks and LCFIs. Principally, this Note recommends a system requiring narrow depository institutions, and if that is politically unattainable, the institution of coinsurance and a prefunded OLF.

B. Give It to Me Baby: What a Modern System Should Look Like

Echoing the proposal by Sheila Bair in her book *Bull by the Horns*, LCFIs should be permitted to own insured depository institutions, but they should only be permitted to operate narrowly as commercial banks conducting traditional banking activities like lending.⁴³⁴ All of an LCFI's securities, derivative, and other speculative activities should be conducted in separate affiliates.⁴³⁵ There should be an ironclad ban on transactions between insured depository institution affiliates and other affiliates in an LCFI,⁴³⁶ with no possibility of waiver. This would prevent the problems that have plagued section 23A, and ensure that insured deposits are never allowed to support highly speculative activities. Lastly, in order to continue to aid the competitiveness of community banks, insured depository institutions that are not part of LCFIs should be permitted to engage in a limited number of nontraditional bank activities.⁴³⁷

This system would end the ability of banks to utilize cheap federally subsidized deposits to fund and profit from speculative activities.⁴³⁸ LCFIs will be forced instead to attract funding from private investors who will charge an interest rate commensurate to the level of risk of the activity.⁴³⁹ Thus, banks and LCFIs will only be able to engage in highly speculative activities if they and their investors decide those activities truly are profitable.

While a system of narrow depository institutions would be the best solution to solve the problems created by deposit insurance, it also represents a radical legal change.⁴⁴⁰ Therefore, instituting narrow banking may be politically impossible. Given that reality, this Note also recommends two smaller reforms that would require little change to the law, but could also substantively improve the system.

First, the FDIC should adopt a system of coinsurance, as was originally contemplated in the Banking Act of 1933.⁴⁴¹ For example, deposits of \$0.01–\$50,000.00 would be 100 percent insured, deposits from \$50,000.01–\$150,000.00 would be 50 percent insured, and deposits from \$150,000.01–\$250,000.00 would be 25 percent insured. This would force

434. See *supra* note 398 and accompanying text; see also BAIR, *supra* note 318, at 329–30.

435. See *supra* notes 403–06 and accompanying text; see also BAIR, *supra* note 318, at 329–30.

436. See *supra* note 405 and accompanying text.

437. See *supra* notes 400–02.

438. See *supra* notes 409–11 and accompanying text.

439. See *supra* notes 409–11 and accompanying text.

440. See *supra* note 415 and accompanying text.

441. See *supra* note 66 and accompanying text.

depositors to have a greater interest in monitoring⁴⁴² their banks, and in turn, subject banks and LCFIs to slightly greater discipline.⁴⁴³ If depositors are concerned they will lose part of their money, they will be more likely to remove it if they become concerned with a bank's health, and this will force banks to either take on less risk or pay higher interest rates to compensate depositors for that risk.⁴⁴⁴ At the same time, because much of their money is still protected, coinsurance should insure against mass panics that would cause bank runs⁴⁴⁵ and protect highly unsophisticated depositors.⁴⁴⁶

Second, the DIF should be eliminated, and the resolutions of both banks and SIFIs should be financed through a new prefunded OLF. Under this system, covered financial institutions (SIFIs and commercial banks) would make a yearly payment to the FDIC that represents a percentage of what it would cost to resolve the institution if it failed. All payments to the OLF would be made at the holding company level.⁴⁴⁷ This means banks that are part of a SIFI will not have to make a separate payment, but that LCFIs, who have not been designated as SIFIs, but operate a commercial bank, will have to pay at the holding company level for the potential resolution of the entire LCFI.⁴⁴⁸ Thus, the focus will no longer be solely on commercial banks, but on the truly important institutions whose failure actually presents the greatest risk to the financial sector and the economy, and will force them to internalize the costs of their risk, not the taxpayers.⁴⁴⁹ This will also capture the reality that many SIFIs and LCFIs flout the rules of section 23A and take advantage of the federal subsidy provided by deposit insurance to their affiliate commercial banks.⁴⁵⁰

442. While some argue that depositors lack the time and sophistication to engage in such monitoring, this may overestimate what monitoring involves. Depositors need not be financial experts, but rather only need to learn that a bank is engaged in something analysts believe is highly speculative. The excessively risky activities or mistakes of banks and financial institutions are often publicized in the mainstream press. Even without a complex understanding of the underlying actions involved, depositors would be sophisticated enough to tell the difference between good and bad. See Ruth Simon, *Mortgage Lenders Loosen Standards: Despite Growing Concerns, Banks Keep Relaxing Credit-Score, Income and Debt-Load Rules*, WALL ST. J., July 26, 2005, at D1 (demonstrating that, even in 2005, there was publicly available knowledge that banks were engaged in high-risk lending practices); see also David Benoit, *From J.P. Morgan's 'Whale' to Facebook's IPO: Deal Journal's Most Read Posts of the Year*, WALL ST. J. DEAL J. (Dec. 31, 2012, 11:48 AM), <http://blogs.wsj.com/deals/2012/12/31/from-j-p-morgans-whale-to-facebooks-ipo-deal-journals-most-read-posts-of-the-year/> (demonstrating that many people were interested in and read about J.P. Morgan's London Whale incident).

443. See *supra* notes 337–41 and accompanying text.

444. See *supra* notes 337–41 and accompanying text.

445. See *supra* note 223 and accompanying text.

446. See CARNELL ET AL., *supra* note 18, at 331 (noting that coinsurance would protect depositors but would also allow for some of the benefits of increased shareholder discipline).

447. See *supra* notes 318–19 and accompanying text.

448. See *supra* notes 318–19 and accompanying text.

449. See BAIR, *supra* note 318, at 335–36.

450. See *supra* note 274 and accompanying text.

CONCLUSION

Too often, the debate on reform has been dominated by concern over TBTF, bailouts, and implicit government guarantees.⁴⁵¹ This is not to say that those issues are unimportant. However, while the public and politicians continue to debate TBTF, deposit insurance continues to provide a subsidy to banks and LCFIs that allows them to artificially create profits by engaging in speculative activities. Indeed, analysts may someday look back at these very activities as the cause of the next financial crisis.

To solve this problem, this Note proposes a system of narrow depository institutions. This proposal would involve substantial changes to the law and the practices of LCFIs, but narrow banking is the most direct way to pry the mouths of LCFIs off the faucet of cheap federally subsidized funds, while at the same time protecting depositors. Yet, as political gridlock in Washington makes wholesale change increasingly unlikely, this Note also proposes smaller measures to improve the current system: coinsurance and prefunding the OLF with assessments charged to bank and SIFI holding companies. While these reforms would not solve the problems created by deposit insurance entirely, they would be an important first step towards creating a safer financial system in the United States. In other words, if the mouths of LCFIs cannot be ripped off the faucet of cheap federally subsidized funds, the United States should at least make the water taste a little more bitter.

451. *See supra* Part II.C and accompanying text.